IN THE

Supreme Court of the United States

October Term, 1979

No. 79-584

Research Equity Fund, Inc.,
Petitioner

v.

The Insurance Company of North America,
Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A, *infra,* pp. 1a-10a) is reported at 602 F.2d 200. The district court's findings of fact and conclusions of law are reprinted at Pet. App. B, *infra,* pp. 11a to 47a.

JURISDICTION

The judgment of the court of appeals was entered on May 31, 1979 (Pet. App. C, *infra,* p. 51a). On July 11, 1979, the court of appeals denied a timely petition for rehearing (Pet. App. D, *infra,* p. 53a). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

QUESTION PRESENTED

The managerial employees of most mutual funds are provided by investment advisers through management contracts with the funds. The question presented in this case is whether, under Section 17(g) of the Investment Company Act of 1940 and Rule 17g-1 thereunder, which protect investors by requiring fidelity bonds for employees of mutual funds having authority to direct the disposition of the mutual fund's assets, a fund's portfolio manager furnished by the investment adviser is an "employee of a registered management investment company" for whom bonding coverage is required.

STATUTE AND REGULATION INVOLVED

Section 17(g) of the Investment Company Act of 1940, 15 U.S.C. § 80a-17(g), as amended,[1] provides:

> The Commission is authorized to require by rules and regulations or orders for the protection of investors that any officer or employee of a registered management investment company who may singly, or jointly with others, have access to securities or funds of any registered company, either directly or through authority to draw upon such funds or to direct generally the disposition of such securities (unless the officer or employee has such access solely through his position as an officer or employee of a bank) be bonded by a reputable fidelity insurance company against larceny and embezzlement in such reasonable minimum amounts as the Commission may prescribe.

[1] The Investment Company Amendments Act of 1970, effective December 14, 1970 (Pub. L. 91-547, § 9(b)) substituted "officer or employee" for "officer and employee" and inserted the parenthetical clause preceding "be bonded."

Rule 17g-1(a) of the Securities and Exchange Commission (17 C.F.R. § 270.17g-1(a)), promulgated under Section 17(g) of the Investment Company Act of 1940, *supra,* provides:

> Each registered management investment company shall provide and maintain a bond which shall be issued by a reputable fidelity insurance company, authorized to do business in the place where the bond is issued, against larceny and embezzlement, covering each officer and employee of the investment company, who may singly, or jointly with others, have access to securities or funds of the investment company, either directly or through authority to draw upon such funds or to direct generally the disposition of such securities, unless the officer or employee has such access solely through his position as an officer or employee of a bank (hereinafter referred to as "covered persons").

STATEMENT

A. Background

Petitioner is the successor to Winfield Growth Fund ("WGF"), an open-end diversified management investment company under the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1—80a-52. Rule 17g-1, promulgated by the Securities and Exchange Commission under Section 17(g) of the Act (15 U.S.C. § 80a-17(g)), required WGF to obtain a fidelity bond against larceny and embezzlement by those of its officers and employees who have access to its funds or securities directly or through authority to draw upon such funds or to direct generally the disposition of such securities. 17 C.F.R. § 270.17g-1(a).

On June 15, 1969, respondent, Insurance Company of North America ("INA"), executed and delivered

two fidelity bonds [2] covering, among others, WGF and Winfield & Co. and insuring against losses resulting from dishonest or fraudulent acts of their officers and employees. WGF "employed [Winfield & Co.] under a management contract . . . to act as its investment adviser" (Pet. App. 2a). The management contract required Winfield & Co. to provide investment research facilities, administrative services and personnel to WGF (Pet. App. 19a). Each of WGF's officers was also an officer of Winfield & Co. (Pet. App. 8a). "Winfield & Co. employees functioned as if they were WGF employees" (Pet. App. 8a). This type of relationship between a mutual fund and an investment adviser is the norm in the mutual fund industry (Pet. App. 8a).

In 1968, Winfield & Co. hired A. Stephen Sanders. Sanders served as a portfolio manager for WGF, working out of Winfield & Co.'s New York offices.[3] (Pet. App. 19a). In this position, he had the responsibility for deciding which securities to purchase or sell for WGF's portfolio (Pet. App. 2a). When he initiated a purchase or sale, Sanders acted through a Winfield & Co. "trader," who placed orders with stockbrokers (Pet. App. 2a).[4] After the stockbroker had confirmed

[2] The bonds were in the form of Brokers Blanket Bonds, Form No. 14, which was originally developed for stockbrokers. Pet. App. 17a. *See* note 23 *infra*.

[3] WGF's assets consisted entirely of the securities and cash maintained in its investment portfolio (Tr. 163). For purposes of investment management, this portfolio was segregated into parts, each segregated part the responsibility of a different portfolio manager (Tr. 385; Tr. 404); ("Tr." refers to the transcript of the trial in the district court.)

[4] Sanders acted under the immediate supervision of an individual who was an officer of both WGF and Winfield & Co. (Pet. App. 2a).

execution of the transaction, WGF reviewed the confirmation and instructed WGF's custodian bank [5] to complete the transaction by paying for and receiving the securities purchased, or by receiving payment for and delivering the securities sold (Pet. App. 2a).

From December 1969 until at least March 1970, Sanders received bribes [6] in return for his causing WGF to purchase securities at prices Sanders knew to be manipulated (Pet. App. 2a-3a, 24a). After the scheme was discovered,[7] WGF incurred substantial losses in selling the securities Sanders had caused it to purchase at artificially inflated prices (Pet. App. 3a).

B. The Decision Of The District Court

Petitioner brought suit against INA in the Northern District of California to recover on its fidelity bonds for the losses resulting from Sanders' dishonesty. After a trial, the district court made extensive findings of fact and conclusions of law and entered a judgment ordering dismissal of petitioner's complaint (Pet. App. 49a).

Finding that Sanders was not an employee of WGF under the terms of the fidelity bonds, the district court apparently concluded that WGF was not entitled to re-

[5] Section 17(f) of the Act, 15 U.S.C. § 80a-17(f), requires that registered mutual funds place their securities and similar investments in the custody of a bank. The Commission has prescribed a form for bank custodian agreements. SEC Guidelines for Preparing Form N-8B-1, 4 CCH Fed. Sec. L. Rep. ¶ 51,301, at p. 39,298 (App. A).

[6] The persons that bribed Sanders were not connected with WGF or Winfield & Co. (Pet. App. 2a).

[7] In 1972, Sanders plead guilty to two counts of an indictment returned in the Southern District of New York (Pet. App. 24a).

covery because it could collect on the bonds only for losses resulting from actions of its officers and employees (Pet. App. 44a-45a). Although the fidelity bonds were joint bonds, covering both WGF and Winfield & Co., the district court's theory seemed to be that only Sanders' direct employer, Winfield & Co., had coverage against Sanders' dishonesty (see Pet. App. 3a-4a, 45a).

The court further held that in any event, a clause in the bonds—commonly known as "the trading loss exclusion" and set forth in the margin [8]—exempted Sanders' activities from coverage (Pet. App. 45a). In the court's view, the losses claimed by WGF as a result of Sanders' dishonesty "arose, directly or indirectly, from trading within the terms of the trading loss exclusion clause of the bonds" (Pet. App. 45a).

After reaching the foregoing conclusions, the district court considered the effect of Section 17(g) of the Act and Rule 17g-1 thereunder. Each of the bonds stated that it was issued "to comply with the rules of the Securities and Exchange Commission" (Pet. App. 15a). The court ruled that the bonds in question were "statutory bonds" that satisfied the requirements of Rule 17g-1 and must be interpreted in light of that rule (Pet. App. 45a).

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[8] Section 1. This bond does not cover:

(e)(1) Any loss resulting directly or indirectly from trading, including all transactions involving the purchase, sale or exchange of securities, with or without knowledge of the Insured, in the name of the Insured or otherwise, whether or not represented by any indebtedness or balance shown to be due the Insured on any customer's account, actual or fictitious, and notwithstanding any act or omission on the part of any Employee in connection with any account relating to such trading, indebtedness, or balance.

Pet. App. 5a.

With respect to this issue, the Securities and Exchange Commission appeared as *amicus curiae,* arguing that for purposes of Section 17(g) and Rule 17g-1, Sanders acted as an "employee" of WGF and engaged in "larceny and embezzlement" for which the Act required bonding coverage.[9] The district court, however, rejected the Commission's arguments and petitioner's similar contentions. The court held instead that an employee of an investment adviser who renders services to a mutual fund may not be considered an "employee" of the fund within the meaning of Section 17(g) and Rule 17g-1 (Pet. App. 46a).

C. The Decision Of The Court Of Appeals

On petitioner's appeal, the Securities and Exchange Commission again appeared as amicus curiae supporting petitioner's interpretation of Section 17(g) and Rule 17g-1 and urging "that the statutory bonds here involved must be held to provide the statutorily required coverage. . . ."[10] Although disagreeing with the district court in a number of respects, the court of appeals affirmed (Pet. App. 10a).

The court of appeals first rejected the district court's ruling that the bonds did not protect WGF for losses resulting from the actions of an employee of Winfield & Co. On the bonds, WGF had not separately listed any officers or employees; but if WGF were to have any coverage, "it must have been intended that it be covered for the acts of those who were employees of the

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[9] *Memorandum of the Securities and Exchange Commission, Amicus Curiae,* at pp. 6-16.

[10] *Statement of the Securities and Exchange Commission, Amicus Curiae,* at p. 3.

other companies" listed on the bonds (Pet. App. 4a). Thus, "[d]espite the fact that Sanders was not an employee of WGF, . . . he was, nevertheless, among the persons for whose acts WGF was covered" (Pet. App. 4a).

The court of appeals held, however, that Sanders' activities came within the terms of the trading loss exclusion [11] of the bonds. Relying on the findings of the district court, the court of appeals thus rejected petitioner's argument that this bond clause "was intended to apply only to the kinds of risk normally encountered by stockbrokers" (Pet. App. 5a).

The court then considered whether the bonds in question, as statutory bonds, must be construed in light of Section 17(g) and Rule 17g-1 to allow recovery for Sanders' illegal practices (Pet. App. 6a-10a). Citing *Index Fund, Inc.* v. *Insurance Co. of North America,* 580 F.2d 1158 (2d Cir. 1978), *cert. denied,* 99 S.Ct. 1226 (1979), the court stated "that when an employee knowingly pays more for an item than it is worth with the intention of enriching the person from whom the purchase is made, this is theft as surely as if the employee had given the other person the money directly" (Pet. App. 7a). Thus, the type of losses suffered by WGF would be encompassed by the terms "larceny" and "embezzlement" as used in Rule 17g-1 and Section 17(g).[12]

Although the foregoing statutory bond analysis would allow recovery on the bonds despite the trading

[11] *See* note 8 *supra*.

[12] The court of appeals for the Second Circuit had so held in *Index Fund, Inc.* v. *Insurance Co. of North America, supra,* 580 F.2d at 1163.

loss exclusion, the court of appeals held that such an analysis is permissible only to the extent that coverage is required by statute. Since Rule 17g-1 required coverage against larceny and embezzlement by mutual fund's officers and employees, petitioner was required to show not only "that Sanders' activities constituted larceny or embezzlement, but also that Sanders was an officer or employee of the" mutual fund, WGF. (Pet. App. 7a).

In this regard, the court of appeals held that Sanders was not an "employee" of the mutual fund within the meaning of Section 17(g) and Rule 17g-1. Although the court agreed with petitioner and the Commission as *amicus curiae* that Sanders acted in a capacity "functionally equivalent to that of officer or employee of a mutual fund" (Pet. App. 9a), the court thought it significant that his salary was paid by Winfield & Co., not WGF, and that he was listed as an employee of Winfield & Co. on the bond application, on the proof of loss filed with INA and "in the annual reports of Winfield & Co. to the Securities & Exchange Commission" (Pet. App. 3a-4a, 7a).[13] As to Congress' intent regarding Section 17(g), the court of appeals noted that investment advisers need not be bonded and that in 1975 Congress rejected legislation that would have required such bonding. (Pet. App. 9a).

[13] The court's reference to "Winfield & Co.'s" annual reports is an apparent error. The court of appeals meant to refer to WGF's reports to the Commission, as the district court's findings of fact make clear (see Pet. App. 21a, Finding of Fact No. 67). These reports also listed Sanders as an officer of WGF; however, WGF's answers to interrogatories did not name Sanders as one of its officers. See Brief for the Appellant in the court of appeals, at p. 22 n.10.

Petitioner, joined by the Securities and Exchange Commission as *amicus curiae,* filed a petition for rehearing, which the court of appeals denied (Pet. App. 53a).

REASONS FOR GRANTING THE WRIT

A. The Extent Of Bonding Coverage Required Under Section 17(g) Of The Act And Rule 17g-1 Is An Issue Of Considerable Importance To The Investing Public And All Registered Investment Companies

The decision of the court of appeals in this case has far-reaching implications. Most "open-end" investment companies or mutual funds are operated like petitioner, with the fund's managerial personnel furnished by an investment adviser pursuant to a management contract. *See Burks* v. *Lasker,* 99 S.Ct. 1831, 1838 (1979).[14] As in this case, the mutual fund's management "selects the fund's portfolio and operates or supervises most other aspects of its business" [15]—a situation "fraught with

[14] *See* H. R. Rep. No. 2337, 89th Cong., 2d Sess. 46 (1966) (*Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth*) (hereinafter "*Public Policy Implications*"). The court below recognized that this relationship between a mutual fund and its investment adviser is the "norm in the industry" (Pet. App. 8a).

[15] *Public Policy Implications* 46. This report further states that (*ibid.*):

> Most mutual funds do not hire employees of their own to provide these managerial skills. They obtain them from a separate entity called an "investment adviser." The fund pays the adviser an "advisory" fee which is almost always a percentage of the fund's net assets. . . . Although the fund itself has a board of directors and one or more executive officers, a substantial portion of the fund's directors and all, or virtually all, of its officers will normally be associated with or employed by its advisers. In most cases all of the compensation that such persons receive for their services to the fund is paid to them by the adviser, not by the fund.
>
> With rare exceptions, most advisers also supply the mutual funds that they manage with office space and with the clerical and accounting personnel necessary to carry on the fund's business. In most—but not in all—cases such services are paid for by the basic advisory fee.

potential conflicts of interest".[16] These are the individuals managing more than $50 billion in assets for millions of mutual fund shareholders,[17] but if the decision below stands, there is no longer any requirement that they be bonded for the protection of investors.[18]

The issue presented here is thus, as the Securities and Exchange Commission has recognized, "of considerable importance to the investing public." [19] Whether mutual fund managers, furnished by investment advisers and serving as the functional equivalent of fund employees,[20] are "employees" of the fund for the purpose of Section 17(g) and Rule 17g-1 is a question that is also of great significance to all "disinterested" di-

[16] *Galfand* v. *Chestnutt Corp.*, 545 F.2d 807, 808 (2d Cir. 1976), quoted in *Burks* v. *Lasker, supra,* 99 S.Ct. at 1838-1839.

[17] *See Hearings on S. 2849 before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs,* 94th Cong., 2d Sess. 7 (1976); *Public Policy Implications* 2.

[18] We use the phrase "no longer" because, as discussed below, there is no doubt that Section 17(g) was intended to cover management personnel furnished to a mutual fund by its investment adviser.

[19] Letter from the General Counsel, Securities and Exchange Commission to District Judge, at p. 1, March 15, 1976, requesting permission to appear as *amicus curiae* in the district court in this case. *See also* Motion of the Securities and Exchange Commission For Leave To File Statement, *Amicus Curiae* (at p. 2) in the court of appeals.

[20] *See* the opinion of the court of appeals, at Pet. App. 9a.

rectors of mutual funds[21] in performing their duty to ensure that proper bonding coverage is maintained.[22]

While many responsible mutual funds may, despite the opinion below, seek to obtain bonds that cover management personnel provided by their investment advisers, other funds may choose not to do so.[23] Even those mutual funds that seek coverage may obtain bonds on such management personnel that do not fully comply with the detailed requirements of Rule 17g-1.[24] Yet the Commission would be powerless to require conformity to its regulations because—if the decision be-

[21] *See Burks* v. *Lasker, supra,* 99 S.Ct. at 1835 n.4, 1840.

[22] *See Securities and Exchange Commission Release No. IC-10393,* Sept. 8, 1978 ("Fidelity Bonding of Registered Management Investment Companies") and note 26 *infra.*

[23] The bonds involved in this case were in a form used generally throughout the mutual fund industry. As the Commission has stated (*SEC Release,* note 22 *supra,* at p. 4):

> Instead of adopting an entirely new fidelity bond form to meet the unique bonding requirements of investment companies, the surety industry has generally used its Stockbrokers Blanket Bond ("Standard Form 14"). The Standard Form 14 was designed specifically to meet the needs of broker-dealers and investment bankers, but it has been used, generally with numerous modifications (i.e. riders), for fidelity coverage of registered investment companies. Due to the distinct differences in organization and methods of operation between brokerage and investment banking firms and investment companies, certain problems have come to the attention of the Division regarding the provisions of the fidelity bond forms presently being used and the applicability of those provisions to the requirements of [Rule 17g-1]....

[24] Rule 17g-1 contains numerous provisions regarding termination clauses, amounts of minimum coverage, modification of coverage, joint bonding, the form of the basic bond and so forth.

low stands—such coverage would in any event be unnecessary.[25]

The issue presented here promises to generate confusion, controversy and litigation for years to come unless it is finally resolved by this Court.[26] In the meantime, the investing public would be exposed to risks that, we submit, are unwarranted. This is peculiarly an area in which a definite and uniform rule should prevail. Only then can the cost of protecting investors against dishonesty by fund managers be spread equitably throughout the mutual fund industry and only then can insurers and mutual funds be certain

[25] The court of appeals rested its decision on its interpretation of Section 17(g) of the Act, thus implicitly assuming that the Commission's Rule 17g-1 required coverage to as great an extent as Congress had permitted. See Pet. App. 8a-10a.

[26] The Commission's *Release* (*see* note 22 *supra*), issued after the district court's decision in this case, can only be described as confusing and ambiguous. In explaining that the effect of the district court's opinion is to exclude persons like Sanders from required coverage, the *Release* (at p. 12) states that "investment companies, which generally have substantially all of their operations conducted by employees supplied by an external investment adviser, also *need* a broad definition of 'employee' in their fidelity bonds" (emphasis added). The *Release* reminds disinterested directors of their fiduciary duty to ensure proper bonding coverage and "strongly suggests" that they carefully examine their fidelity bonds in light of the *Research Equity* decision and obtain opinions from their insurance carriers and legal counsel "with respect to the complex legal issues involved" (*Release* at pp. 13-14).

No mutual fund director reading this *Release* would be able to say with any assurance whether he must, in order to fulfill his fiduciary obligations, seek a revised bond to cover employees furnished by the fund's investment adviser. The court of appeals decision in this case, with which the Commission disagrees, scarcely ends the confusion.

of the coverage that, at a minimum, must be maintained for the protection of investors.

B. The Court Of Appeals Erred In Interpreting Section 17(g) Of The Act

While the importance of the issue presented here is, in itself, enough to warrant review, we submit that the Court should also grant the petition because the decision below is so plainly in error. As we next discuss, the language, purpose and legislative history of Section 17(g) of the Act leave no doubt that Congress intended the bonding requirements to include persons, such as Sanders, working as a mutual fund's portfolio manager pursuant to a management contract between the mutual fund and its investment adviser.

The persons covered by the Section 17(g) bonding provision include "any . . . employee of a registered management investment company who may singly, or jointly with others, have access to securities or funds of any registered company . . . through authority . . . to direct generally the disposition of such securities . . . ." This language can reasonably bear a construction that includes, as "any employee of" a mutual fund, portfolio mangers supplied by an investment adviser. While both courts below stressed that here the portfolio manager's salary was paid by the investment adviser rather than the mutual fund (Pet. App. 3a, 7a), that is hardly determinative under Section 17(g). The Act expressly recognizes, indeed requires in certain circumstances, that mutual fund executives receive their salaries from the investment adviser. See 15 U.S.C. § 80a-10(d) (in order for a mutual fund's board of directors to have a certain composition it is required that *"all executive salaries and executive expenses and office rent of such investment company are paid by such investment adviser."*) (emphasis added); *Galfand* v. *Chestnutt Corp., supra,* 545 F.2d at 810. Moreover, the court of appeals acknowledged that portfolio managers furnished by investment advisers act in a capacity "functionally equivalent to that of officer or employee of a mutual fund" (Pet. App. 9a) and that in such instances the investment adviser is itself *"employed* under a management contract" with the mutual fund (*id.* at 2a) (emphasis added).[27]

It is no answer to say, as the court of appeals did, that Congress authorized bonding coverage for a mutual fund's officers and employees, but not for portfolio managers like Sanders (Pet. App. 8a-9a). That not only assumes the point at issue, but also flatly contradicts the legislative history of Section 17(g), which the court of appeals evidently failed to consider.[28]

The danger sought to be avoided by Section 17(g) is apparent. Congress knew that the management of most mutual funds was provided through a contract with an outside investment adviser (Pet. App. 8a). Congress also knew from the exhaustive Investment Trust Study conducted by the Commission[29] that "Portfolio man-

[27] During the Senate hearings on the proposed Investment Company Act, the Commission's spokesman described the various methods by which mutual funds compensate their outside investment advisers, referring to one method—a fixed fee—as a "salary basis." *Hearings on S.3580 Before a Subcommittee of the Senate Committee on Banking and Currency,* 76th Cong., 3d Sess. 251 (1940) (hereinafter "*Senate Hearings*")

[28] This Court has held with respect to other federal statutes that the term "employee" must be interpreted in light of the purposes of the statute and its legislative history. *See, e.g., United States* v. *Silk,* 331 U.S. 704, 711-712 (1947).

[29] *See* note 31 *infra.*

agement is the primary duty of managers of investment companies;" that the "degree of success or failure" in the "management of assets consisting of participations in other enterprises" determined "the effect on the investors' money"; and that "[w]hen situations arise which preclude the unbiased rendition of this service the likelihood of harm to investors is greatly increased." [30] This harm to investors can, of course, be avoided by authorizing the Commission to require that portfolio managers (such as Sanders) be bonded. In Section 17(g) of the Investment Company Act of 1940 Congress did precisely that.

Although this Court has instructed that the Investment Trust Study must form "the initial basis for any evaluation of the Act," [31] there is no indication that the court below heeded that instruction. Had the court done so, it would have discovered that a bill [32] was introduced containing "in legislative form and language the recommendations of the Commission based on its detailed study of investment companies." [33] Section 17(g)(2) of this bill authorized the Commission to require for the protection of investors "that any person . . . registered under Section 9 be required to be

[30] Investment Trust Study, Part III, reprinted in H.R. Doc. No. 136, 77th Cong., 1st Sess. 2579-2580 (1941). *See also Senate Hearings* 250-253.

[31] *United States* v. *National Ass'n of Sec. Dealers, Inc.*, 422 U.S. 694, 705 (1975). Portions of the Study in addition to those cited in 422 U.S. at 705, n.14, are contained in H.R. Doc. No. 136, 77th Cong., 1st Sess. (1941) (final chapter of Part III) and H.R. Doc. No. 246, 77th Cong., 1st Sess. (1941) (Parts IV and V).

[32] S. 3580, 76th Cong., 3d Sess. (1940).

[33] Investment Trust Study, Part V (Conclusions and Recommendations), H.R. Doc. No. 246, 77th Cong., 1st Sess. 383 (1941).

bonded. . . ." [34] The persons registered under Section 9 of the bill included not only each officer and director but also each *"manager" "of or for* a registered management investment company." [35]

Section 17(g) of the original bill, which contained the Commission's recommendations, thus clearly covered persons such as Sanders.[36] When the original bill was revised by the Commission and industry representatives working together,[37] the registration requirement of Section 9 was deleted.[38] Section 17(g), which originally described the persons covered by referring to Section 9's registration requirement, was therefore also revised to include the language at issue in this case. But with respect to the revised Section 17(g), the

[34] *Senate Hearings* 13.

[35] *Senate Hearings* 7 (emphasis added).

[36] Personnel supplied to investment companies through contracts with investment advisers were referred to in the Senate hearings as the investment company's "managers" or "management". *See, e.g., Senate Hearings* 251-253. These individuals, pursuant to "management contracts," could be given the power to "manage the portfolio." *Id.* at 251.

[37] S. Rep. No. 1775, 76th Cong., 3d Sess. 1 (1940). The revised bill (S. 4108) had the endorsement of the Commission and the industry and was primarily the product of Commission counsel David Schenker and industry representative Alfred Jaretzki, Jr., of the firm of Sullivan & Cromwell. *See, e.g., Senate Hearings* 1107-1109, 1123. S. Rep. No. 1775, 76th Cong., 3d Sess. 1-2 (1940).

[38] *See* Testimony of David Schenker, Chief Counsel, SEC Investment Trust Study, in *Senate Hearings* 1112, explaining the revision of Section 9. The revised bill, introduced as S. 4108 and H.R. 10065, is reprinted in *Hearings on H.R. 10065 before a Subcommittee of the House Interstate and Foreign Commerce Comm.*, 76th Cong., 3d Sess. 1-44 (1940).

Commission's representative testified that no substantial change was intended.[39]

Since the exclusion of managers in Sanders' position from bonding coverage would have been a substantial revision of Section 17(g),[40] it follows that Congress must have intended such persons to be included within the meaning of "employee" of a mutual fund. The contrary conclusion of the court below conflicts not only with the legislative history of Section 17(g) but also with this Court's holding in *United States* v. *National Association of Securities Dealers, Inc., supra,* 422 U.S. at 720, that the Investment Company Act must be interpreted "in a manner most conducive to the effectuation of its goals." [41]

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[39] *See* Testimony of David Schenker, Chief Counsel, SEC Investment Trust Study, in *Senate Hearings* 1116. Schenker stated that "Section 17, 'Transactions of certain affiliated persons and underwriters,' is substantially the same provision as in the old bill." After describing specific revisions in some subsections of Section 17, he stated in regard to the remaining subsections—including Section 17(g)—that "those other provisions are substantially the same" as in the old bill. *Ibid.*

That no change was made or intended is understandable in light of the facts that although an industry spokesman specifically criticized numerous provisions in the old bill, he voiced no objection to the bonding provision in Section 17(g) of the old bill (*Senate Hearings* 1052-1059); and that the original bill was rewritten by the Commission and the industry to resolve their differences (*see* note 37 *supra*).

[40] As stated above (p. 15 *supra*), Congress knew that mutual funds had a unique system of management contracts with investment advisers "where the officers and directors, if they have not done it in toto, have delegated a susbtantial part of their managerial functions." Testimony of David Schenker, *supra,* in *Senate Hearings* 251.

[41] One of the declared purposes of the Act is to eliminate certain conditions that adversely affect investors and one of those conditions, set forth in Section 1 of the Act, occurs when an investment company's portfolio is selected in the interest of the investment adviser rather than in the interests of the shareholders—which of course describes Sanders' actions in this case. *See* 15 U.S.C. § 80a-1(b)(2). *See also Index Fund, Inc.* v. *Insurance Company of North America, supra,* 580 F.2d at 1162.

The court below discussed none of the foregoing history of Section 17(g), which we submit demonstrates that the court plainly erred in its interpretation of that provision. Moreover, the reasons the court stated in support of its interpretation do not withstand examination. The court, for example, thought it important that the "Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1, *et seq.* . . . contained no requirement that investment advisers be bonded" (Pet. App. 9a). While it is hardly certain what significance one should attach to this observation, it fails to take account of the fact that investment advisers whose only clients were mutual funds were not in any event covered by the registration and regulatory provisions of that Act.[42] In other words, there was "a distinct separation of investment advisers under the two" Acts.[43]

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[42] Section 203(b)(2) of the Investment Advisers Act, 54 Stat. 850 (1940); *see also* Sections 204 and 205, 54 Stat. 852 (1940). This exemption was removed, effective December 14, 1971, by the Investment Company Amendments Act of 1970, Sections 24(a), 25, 30, Pub. L. No. 91-547, 84 Stat. 1430, 1432-33, 1436.

As the Commission pointed out in its Memorandum *Amicus Curiae* in Support of Rehearing in the court of appeals (at p 3, n.4), "until 1971 the major regulatory requirement of the [Investment Advisers] Act—the provision regulating advisory contracts—was not applicable to contracts with clients that were investment companies. *See* Section 205 of the Investment Advisers Act, 54 Stat. 852 (1940), amended (effective December 14, 1971) by the Investment Company Amendments Act of 1970, *supra,* Section 25, 84 Stat. 1433."

[43] *House Hearings,* note 38 *supra,* at p. 31 (statement of Rep. Boren).

The only other basis the court of appeals offered for its interpretation of Section 17(g) consists of an obvious misconception regarding later legislation. The court said (Pet. App. 9a):

> In 1975, Congress considered amending the Investment Advisers Act to authorize the S.E.C. to require bonding of investment advisers. In rejecting such legislation, Congress obviously contemplated that the bonding requirement would be applicable only to those persons who are in fact officers or employees of the mutual fund.

Although the court cited no legislative materials in support of its statements, it apparently was referring to hearings held in 1976 (rather than 1975) by a Senate subcommittee on proposed amendments to the Investment Advisers Act of 1940 that would have authorized the Commission to issue rules "with respect to the financial responsibility of investment advisers."[44] It is difficult to see how Congress' rejection in 1975 or 1976 of an amendment to another statute bears on what the 1940 Congress intended in Section 17(g). But in any event the fact is that "Congress" did not "reject" the proposed amendment. Instead, the bill was reported favorably by the Senate Banking Committee,[45] but never reached a floor vote in either House.[46] All that

[44] *Hearings on Investment Advisers Act Amendments of 1976 (S.2849) before the Subcomm. on Securities of the Senate Committee on Banking, Housing and Urban Affairs*, 94th Cong., 2d Sess. 2 1976).

[45] S. Rep. No. 94-910, 94th Cong., 2d Sess. (1976).

[46] As a result of the court's interpretation of Section 17(g), which led it to conclude that Sanders was not an "employee" under that provision, the court found it unnecessary to engage in a statutory bond analysis, under which the court would not

can be said with assurance is that "Congress obviously contemplated" (Pet. App. 9a) nothing.

If the court believed that later legislation might bear on the question presented by this case, the court should have considered the amendment to Section 17(g) in 1970 excluding certain persons from bonding coverage by adding the parenthetical clause "(unless the officer or employee has such access solely through his position as an officer or employee of a bank.)"[47] This is an express recognition by Congress that although an individual is considered an employee of another organization (a bank) for some purposes, he may nevertheless also be considered an employee of a mutual fund for the purpose of Section 17(g). If the decision of the court of appeals in this case were correct, however, this amendment would have been unnecessary: there would be no need to exclude bank employees who are presumably hired and paid by the bank because, under the court's interpretation, that fact would preclude them from also being considered "employees" of a mutual fund for which bonding could be required.

In sum, on the basis of its Investment Trust Study the Commission recommended that portfolio managers

have given effect to the bond's trading loss exclusion clauses (Pet. App. 7a). *See Index Fund, Inc.* v. *Insurance Company of North America*, *supra*, 580 F.2d at 1162; *American Casualty Co. of Reading, Pa.* v. *Irwin*, 426 F.2d 647 (5th Cir. 1970); 9 Appleman, *Insurance Law and Practice*, § 5277 (1943 ed. and 1979 Supp.) ("The provisions of a statute pursuant to which a bond is given are to be read into the bond and considered a part of it. . . ." (*Ibid.*).

[47] *See* note 1 *supra*. Under Section 17(f) of the Act, 15 U.S.C. § 80a-17(f), investment companies must place their securities and other assets in the custody of a bank.

serving mutual funds be covered by Section 17(g)'s bonding requirements; the original bill embodied this recommendation; although Section 17(g) was rewritten for reasons explained above, no substantial change was made or intended; and the exclusion from Section 17(g) coverage of mutual fund managers supplied by investment advisers would have been a substantial change since Congress knew that the employees of most mutual funds were furnished by investment advisers. The foregoing legislative history, which the court of appeals neither cited nor discussed,[48] demonstrates that a portfolio manager like Sanders is to be considered an employee of the mutual fund for purposes of Section 17(g) and Rule 17g-1. As we have indicated, the reasons offered by the court for its contrary result do not in any way support its interpretation of Section 17(g).[49]

[48] Nor is there any indication that the court gave any weight to the Commission's interpretation of Section 17(g) and its Rule 17g-1, which the Commission defended in *amicus curiae* filings from the district court through the petition for rehearing in the court of appeals. *Compare United States* v. *National Association of Securities Dealers, supra,* 422 U.S. at 718-719, 729.

[49] There is no rational basis for rejecting petitioner's claims on the bonds here, but allowing recovery in *Index Fund, Inc.* v. *Insurance Co. of North America, supra,* which involved the same form of bonds issued in this case and the same fraudulent scheme that Sanders participated in here. The resulting losses in both cases were the kind Congress sought to protect investors against, as the Second Circuit recognized. 580 F.2d at 1162-1163. To be sure, the perpetrator in *Index Fund* was a named officer of the mutual fund, while here the perpetrator was a portfolio manager supplied by the investment adviser. From the point of view of investors, however, the harm is identical and neither of the courts below suggested any reason why Congress and the Commission, in seeking to protect investors from such harm, would have distinguished the two situations.

CONCLUSION

The case is important and the decision below is plainly in error. The petition for a writ of certiorari should be granted.

Respectfully submitted,

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October 1979.

APPENDIX

APPENDIX A

In the United States Court of Appeals
for the Ninth Circuit

No. 77-1467

Research Equity Fund, Inc., *Appellant*,

v.

The Insurance Company of North America, *Appellee*.

Appeal from the United States District Court for the Northern District of California

OPINION

Filed May 31, 1979

Before: Wright and Kilkenny, Circuit Judges, and Pfaelzer,* District Judge.

Pfaelzer, District Judge:

This case involves certain fidelity bonds issued to appellant Research Equity Fund, Inc., formerly Winfield Growth Fund ("WGF"), a mutual fund, by appellee Insurance Company of North America ("INA"). Jurisdiction is based upon diversity of citizenship, 28 U.S.C. § 1332. The District Court held that the bonds did not cover the losses suffered by appellant and entered judgment for INA. We affirm.

Facts

WGF is a Maryland corporation registered as a management investment company under the Investment Company Act of 1940 ("the Act"), 15 U.S.C. §§ 80a-1, *et seq.* It is

* Of the Central District of California.

subject to the requirements of the Act and to the rules thereunder. On June 15, 1969, the effective date of the bonds in question, Rule 17g-1, promulgated pursuant to Section 17(g) of the Act, required that registered management investment companies maintain a fidelity bond against:

> larceny and embezzlement, covering each officer and employee of the investment company, who may singly or jointly with others, have access to securities or funds of the investment company, either directly or through authority to draw upon such funds or to direct generally the disposition of such securities . . . .

Winfield & Co. was employed under a management contract with WGF to act as its investment advisor. Winfield & Co. purchased the bonds from INA on behalf of various corporate entities known as the Winfield Complex, of which WGF was a part.

A. Stephen Sanders was an employee of Winfield & Co., assigned to manage various portfolios, including that of WGF. It was his responsibility to arrive at decisions with respect to the securities to be purchased or sold for WGF's portfolio. Sanders' recommendations as to the securities to be purchased or sold were subject to the approval of his superior at Winfield & Co., who was an officer of both Winfield & Co. and of WGF. Orders for the securities transactions were placed with the "trader" who was an employee of Winfield & Co. responsible for the execution of the orders through stockbrokers. Upon examination of confirmations received from executing brokers authorized officers of WGF would then direct WGF's custodian bank to pay for and accept delivery of securities purchased or to receive payment for and deliver securities sold.

During the period from December, 1969, through March, 1970, Sanders received bribes from persons who were not employees of WGF or Winfield & Co. for recommending the purchase of certain securities at prices Sanders knew to be manipulated.[1] As a result of Sanders' recommendations, WGF purchased several securities at artificially inflated prices, and suffered losses in selling them when the scheme was discovered. It is for these losses which WGF seeks to recover from INA.

The District Court held for INA, concluding that Sanders' conduct was not covered by the bonds. Appellant raises several contentions in this regard, and we deal with each in turn.

Persons Covered By The Bonds

Appellant contends that Sanders was an employee of WGF and that WGF is therefore covered under the bonds for losses resulting from Sanders' activities. The trial court made detailed findings with respect to Sanders' status as an employee and concluded:

> Considering all the circumstances of this case, including the definition of "employee" in the bonds, the Fund's representations to the S.E.C., and the Fund's representations to INA, A. Stephen Sanders was not an officer or employee of [WGF] for the purposes of coverage under the Winfield Bonds. Conclusion of Law No. 5.

The evidence clearly supports the finding that Sanders was an employee of Winfield & Co., not of WGF. He was hired and paid by Winfield & Co. He was listed as an employee of Winfield & Co. on the application made to INA for the bonds and in the annual reports of Winfield & Co. to the Securities & Exchange Commission ("S.E.C."). Fur-

[1] An indictment was returned in the United States District Court for the Southern District of New York against Sanders and others who had participated in this and similar conspiracies. Sanders ultimately plead guilty to counts 21 and 29 of the indictment. *USA* v. *Hagopian, et al.*, 72 Cr. 994, S.D.N.Y. (1972).

ther, in the proof of loss filed with INA, appellant stated under oath that Sanders was an employee of Winfield & Co.

Despite the fact that Sanders was not an employee of WGF, our reading of the language of the bonds leads us to conclude that he was, nevertheless, among the persons for whose acts WGF was covered. The bonds provided that INA would "indemnify and hold harmless the Insured" from "[l]oss through any dishonest or fraudulent act of any of the Employees . . . ." Paragraph 1 of the Declarations page of the bonds defined all of the companies listed jointly as the "Named Insured." The companies listed included WGF and Winfield & Co. The bonds defined the word "employee" as follows:

> Wherever used in this bond, Employee and Employees shall be deemed to mean, respectively, one or more of the Insured's officers, clerks and other employees employed by the Insured during the currency of this bond . . . .

Attached to the bond application was a list of the "employees" to be covered. Twenty-six persons were listed under the heading Winfield & Co., Inc., and three were listed under Winfield Distributors, Inc., the entities who respectively paid their salaries. WGF had no employees of its own, and, although it had officers, there were no persons separately listed for WGF. Thus, if WGF was to have any coverage at all, it must have been intended that it be covered for acts of those who were employees of the other companies. Certainly the phrase "any of the employees" of the insured encompassed Sanders. Both Winfield & Co. and WGF were included in the definition of named insured; consequently, INA cannot avoid liability on the basis that Sanders was not an employee of WGF.

The Trading Loss Exclusion

The bonds issued to WGF and the other joint insureds contained the following provision:

Section 1. This bond does not cover:

. . . .

> (e)(1) Any loss resulting directly or indirectly from trading, including all transactions involving the purchase, sale or exchange of securities, with or without the knowledge of the Insured, in the name of the Insured or otherwise, whether or not represented by any indebtedness or balance shown to be due the Insured or any customer's account, actual or fictitious, and notwithstanding any act or omission on the part of any Employee in connection with any account relating to such trading, indebtedness, or balance.

This provision, commonly known as the trading loss exclusion, was held by the District Court to bar WGF's recovery against INA. However, WGF contends, as it did below, that the trading loss exclusion is not applicable to the losses occasioned by Sanders' activities. In support of this contention, WGF argues that the term "trading" as used in the quoted provision is ambiguous. More specifically, WGF argues that this type of bond was developed for stockbrokers and that the trading loss exclusion was intended to apply only to the kinds of risks normally encountered by stockbrokers. Since it is not a stockbroker, WGF argues that the exclusion should be held inapplicable to it.

WGF's argument is, however, foreclosed by the careful and detailed findings of the District Court. The District Court found that the term "trading" is well understood in the industry,[2] and particularly by WGF and INA. The term

[2] It is significant to note that in the Investment Company Act of 1940, Congress recognized that mutual funds trade, stating that "the principal activities of such companies [are] investing, reinvesting, and trading in securities." 15 U.S.C. § 80a-1(a)(2).

trading was frequently used by WGF to describe its activities, as evidenced by, *inter alia,* its minutes and internal memoranda. The District Court also found that there is no common understanding in the insurance brokerage industry that the trading loss exclusion applies only to stockbrokers. In fact, INA offered to waive this exclusion for WGF in consideration for an additional premium, but this coverage was declined.[3] The District Court found that other mutual funds did in fact purchase this coverage. After examining the record carefully, we have concluded that the findings of the District Court are fully supported by the evidence. We are thus bound by the findings below and we hold the trading loss exclusion applicable to WGF.

Misrepresentation

WGF argues that it was misled by INA's agent into believing that it was covered by the bonds for any losses resulting from the activities of the portfolio managers. However, the District Court found that WGF relied primarily on the opinion of its legal counsel in deciding on its coverage, and was not misled by INA. These findings are not clearly erroneous, and are binding on us on appeal.

Statutory Bond

WGF argues that even if the trading loss exclusion precludes recovery for Sanders' activities, the bonds should be read to provide such coverage because they were issued as statutory bonds. The general rule is as follows:

> A statutory bond will be reviewed in the light of the statute creating the duty to give security. It will be generally held that the provisions of the statute and regulations will be read into the bond. [Citations omitted] So also, if a statutory bond contains provisions

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[3] The trial court found that the additional premium for trading loss coverage was 35% to 50% over the basic cost.

> which do not comply with the requirements of law, they may be eliminated as surplusage and denied legal effect. *American Casualty Co. v. Irvin,* 426 F.2d 647, 650 (5th Cir. 1970).

In order to prevail on the statutory bond theory, WGF must first establish that the type of loss WGF suffered is encompassed by the terms "larceny" and "embezzlement" as they are used in Rule 17g-1, quoted above. INA argues that these terms, in their accepted interpretations, do not cover the acts attributed to Sanders. However, it is our opinion that when an employee knowingly pays more for an item than it is worth with the intention of enriching the person from whom the purchase is made, this is theft as surely as if the employee had given the other person the money directly. Disguising the theft as a purchase does not make it any less a theft. *Index Fund, Inc. v. Insurance Co. of North America,* 580 F.2d 1158 (2d Cir. 1978); *See generally Brown v. Bullock,* 294 F.2d 415, 419-420 (2d Cir. 1961).

Arguably then, the trading loss exclusion here could, under the statute, be interpreted so as not to exclude losses occasioned by Sanders' activities. However, interpretation of a bond to provide coverage beyond its literal terms is permissible only to the extent that such coverage is required by the statute. Rule 17g-1 requires that management investment companies obtain coverage against larceny or embezzlement committed by its officers and employees. Thus, in order to limit the scope of the trading loss exclusion and thereby imply coverage beyond the express terms of the bonds, appellant must not only show that Sanders' activities constituted larceny or embezzlement, but also that Sanders was an officer or employee of the management company, WGF.

With regard to this second requirement, we have concluded above that although Sanders was covered under the bonds, he was not in fact an employee of WGF. This

would seem to preclude the application of the statutory bond analysis in this case.[4] WGF argues, however, that the term "officer and employee of the [management] investment company" in Rule 17g-1 should include individuals such as Sanders. WGF points out that it had no employees of its own, and that the Winfield & Co. employees functioned as if they were WGF employees. Furthermore, a close relationship existed between the two companies; all of the WGF officers were also officers of Winfield & Co. Thus, although Sanders was not an employee of WGF, he was serving in a position functionally equivalent to that of an officer or employee.

However, as WGF concedes, this type of special relationship between investment advisers and mutual funds is the norm in the industry. There is evidence that Congress and the S.E.C. were aware of this practice when Section 17(g) was passed and the rules pursuant thereto promulgated.[5] It is significant then that coverage was required

[4] This is wholly consistent with the analysis in ***Index Fund, Inc.* v. *Insurance Co. of North America***, 580 F.2d 1158 (2d Cir. 1978), wherein it was conceded that the person who participated in the scheme to defraud the mutual fund was an employee of that fund.

[5] The Act defines the term "Investment Adviser" as:

> (A) any person (other than a bona fide officer, director, trustee, member of an advisory board, or employee of such company, as such) who pursuant to contract with such company regularly furnishes advice to such company with respect to the desirability of investing in, purchasing or selling securities or other property, or is empowered to determine what securities or other property shall be purchased or sold by such company, and (B) any other person who pursuant to contract with a person described in clause (A) of this paragraph regularly performs substantially all of the duties undertaken by such person described in said clause (A) .... 15 U.S.C. § 80a-2(a)(20)

In 1966, the "Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company

for officers and employees of mutual funds, but not for persons such as Sanders acting in capacities functionally equivalent to that of officer or employee of a mutual fund.

Furthermore, separate legislation was enacted simultaneously with the Investment Company Act of 1940 governing the conduct of investment advisers. *See* Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1, *et seq.* This legislation contained no requirement that investment advisers be bonded. In 1975, Congress considered amending the Investment Advisers Act to authorize the S.E.C. to require bonding of investment advisers. In rejecting such legislation, Congress obviously contemplated that the bonding requirement would be applicable only to those persons who are in fact officers or employees of the mutual fund.[6] Per-

Growth," H.R. Rep. No. 2337, 89th Cong., 2d Sess. (1966), was submitted to Congress. Page 87 thereof states:

> Like typical business enterprises elsewhere in the economy, some investment companies, especially closed end companies, are internally managed by officers and staffs employed directly by the companies. As noted in Chapter II, however, the management function of most mutual fund is contracted out to an external investment advisory organization, the principals of which are the persons who organized and promoted the fund from its inception or the succsessors of such persons. In such instances, the analysts and other professional personnel on whose expertise the fund relies are employees of the advisor, not of the fund ....

[6] In its statement to Congress in support of the proposed amendments, the SEC stated that:

> [a]t the present time there are no specific requirements imposed by the Act on investment advisers in order to assure that they have the financial strength necessary to carry out their functions in a manner consistent with their obligations to clients, nor are they subject to bonding requirements to prevent losses to clients which might result from embezzlement, misappropriation, breach of duty, or insolvency. [1973-1976 Transfer Binder] Mutual Funds Guide (CCH) ¶ 10,244 at 13,384.

sons such as Sanders who are investment advisers, even though "empowered to determine what securities or other property shall be purchased or sold" by the mutual fund, 15 U.S.C. § 80a-2(a)(20), were not required to be bonded.

Since the statute does not require coverage for the losses suffered by WGF at the hands of someone such as Sanders, the trading loss exclusion in the bonds must be given full legal effect in the present case. We thus affirm the judgment of the District Court.

Affirmed.

APPENDIX B

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

No. C-74-1174 ACW

RESEARCH EQUITY FUND, INC., *Plaintiff,*

vs.

THE INSURANCE COMPANY OF NORTH AMERICA, *Defendant.*

No. C-73-2178 ACW

PERFORMANCE PLUS FUND, LTD., *Plaintiff,*

vs.

WINFIELD & CO., INC., ET AL., *Defendants and Third-Party Plaintiffs,*

vs.

MARK F. HOPKINS & CO., INSURANCE BROKERS, INC., A CORPORATION, ET AL., *Third-Party Defendants.*

FINDINGS OF FACT AND CONCLUSIONS OF LAW

Original Filed Dec. 16, 1976

These actions came on regularly for trial on February 9, 1976, before the Court, Honorable Albert C. Wollenberg, District Judge, presiding without a jury, a jury having expressly been waived. Said actions having been heard, evidence both oral and documentary having been introduced, and said actions having been submitted for a decision, the Court enters the following findings of fact and conclusions of law.

Findings of Fact

1. Research Equity Fund, Inc. is a corporation organized and existing under the laws of the state of Maryland.

2. Research Equity Fund, Inc. was formerly known as Winfield Growth Fund, Inc., (WGF) and, during the period 1968-1972, was a corporation organized and existing under the laws of the state of Delaware. Research Equity Fund, Inc. will hereinafter be referred to as "WGF."

3. WGF is registered as an open-end diversified management investment company under the Investment Company Act of 1940. 15 U.S.C. §§ 80a-1 et seq. WGF's shares are publicly held.

4. WGF is subject to the requirements of the 1940 Act and the "Rules and Regulations" thereunder, including the bonding requirements of Section 17(g) and Rule 17g-1 thereunder. 15 U.S.C. § 80a-17(g); 17 C.F.R. § 270.17g-1.

5. WGF's principal office and place of business is at 155 Bovet Road, San Mateo, California.

6. Defendant Insurance Company of North America (INA) is a Pennsylvania corporation with its principal office and place of business at 1600 Arch Street, Philadelphia, Pennsylvania, is authorized to and does engage in the business of underwriting contracts of insurance and suretyship in the state of California, and maintains an office for that purpose at 1 Embarcadero, San Francisco, California, and at 855 Lenzen Avenue, San Jose, California.

7. Performance Plus Fund, Ltd. (hereinafter "PPF") was, during the relevant period, a diversified open-end investment company, incorporated under the Canada Corporations Act. It is not a registered management investment company under the Investment Company Act of 1940.

8. PPF's principal place of business was, during the relevant period, 110 Place Cremazie, Montreal, Quebec, Canada.

9. PPF's portfolio securities, and cash and other assets, were during the relevant period held by the Bank of Montreal Trust Company, 2 Wall Street, New York, New York.

10. Purchases and sales of PPF's portfolio securities were executed inter alia, through brokers in the United States, and on stock exchanges in the United States.

11. Franklin Research, Inc. is a Delaware corporation whose principal place of business is 155 Bovet Road, San Mateo, California. Franklin Research, Inc. (hereinafter "Winfield & Co.") is a successor to Winfield & Co., Inc. ("Winfield") which was, at all times relevant hereto, an investment advisor.

12. Winfield Associates, Inc. (hereinafter "Associates") was, at all times relevant hereto, a California corporation, doing business in the Northern District of California.

13. As commonly understood in the securities industry, an investment adviser, is a person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities. An investment advisor does not, and may not, purchase or sell securities itself, but must place orders with licensed stockbrokers for the purchase and sale of securities on behalf of clients. Winfield & Co., and Associates were at all times material hereto investment advisers.

14. During the period from January 1, 1968, to June 15, 1972, Section 17(g) of the 1940 Act provided, in pertinent part, that the Securities and Exchange Commission, by rules and regulations, could require that registered management investment companies maintain a fidelity bond covering

> "any officer or employee of a registered management investment company who may singly, or jointly with others, have access to securities or funds of any registered investment company, either directly or through authority to draw the disposition of such securities"

against "larceny and embezzlement. . . ."

15. During the period from January 1, 1968, to June 15, 1972, Rule 17g-1, adopted by the Commission, did require WGF to maintain such coverage.

16. On June 15, 1969, defendant INA, in consideration of agreed premiums duly paid to it, executed and delivered two Brokers Blanket Bonds, Form No. 14 (referred to hereafter as the "Winfield Bonds"):

A. Bond No. S626242, in the amount of $1,800,000 with a deductibility rider in the amount of $200,000, which was effective, as amended from time to time, from June 15, 1969, through June 15, 1972.

B. Bond No. S626243, in the amount of $200,000 providing coverage of the deductible portion of Bond No. S626242, which was effective, as amended from time to time, from June 15, 1969, through June 15, 1972.

The persons named as "Insureds" under said bonds included Winfield Growth Fund, Winfield & Co., and Winfield Associates. Each of said bonds define the term "employees" to include "one or more of the Insured's officers, clerks and other employees."

17. On or about January 1, 1970, defendant INA executed and delivered to Meridian Capital Corporation, Meridian Management Corporation and Index Fund, Inc., among other insureds, a Broker's Blanket Bond, Form 14, No. S626228 (hereafter the "Meridian Bond") in the sum of $25,000. This bond was increased to $100,000 effective April 3, 1970.

18. PPF is not an insured under any of the three said bonds herein enumerated.

19. On December 29, 1970, notice was sent to Meridian Capital Corporation terminating the Meridian Bond effective January 29, 1971.

20. Notice of said cancellation of the Meridian Bond was sent to the Securities and Exchange Commission on January 11, 1971.

21. On May 19, 1972, the Winfield Bonds were cancelled effective 30 days thereafter, and notice of said cancellation of the Winfield Bonds was sent to the insureds as well as the Securities and Exchange Commission on May 19, 1972.

22. Among the provisions of each of the bonds were the following:

A. "The losses covered by this Bond are as follows:

DISHONESTY

(A) Any loss through any dishonest act of any of the Employees, committed anywhere and whether committed directly or by collusion with others, including loss of Property through any such act of any of the Employees.

ON PREMISES

(B) Any loss of Property through robbery, burglary, common-law or statutory larceny, theft. . . ."

23. Each of the bonds included an "SEC Cancellation Clause Rider" stating that it was

"For use with Brokers Blanket Bonds, Form 14 Basic and 14 Broad, when issued to registered management investment companies, to comply with the rules of the Securities and Exchange Commission."

24. On the Declarations page of each bond, immediately following the amount of the bond, each bond contained in subparagraph 3(b) entitled "Sub-Limits" the following language:

"The liability of the Underwriter as stated in (a) above is further limited to the amount specified below

with respect to the following coverages. The amounts specified below shall be part of and not in addition to the Amount of Bond, and Section 7 of the bond shall be subject to the amounts specified below."

". . ."

". . ."

"(3) Trading Loss, under Insuring Clause (A). (When an amount is shown for this Sub-Limit (3), Section 1(e) (1) is deleted and Section 1(e) (2) is substituted therefor) . . . $————

25. Section 1(e) (1) of each of the bonds reads as follows:

"Section 1. This bond does not cover.

". . .

"(e)(1) Any loss resulting directly or indirectly from trading, including all transactions involving the purchase, sale or exchange of securities, with or without the knowledge of the Insured, in the name of the Insured or otherwise, whether or not represented by any indebtedness or balance shown to be due the Insured on any customer's account, actual or fictitious, and notwithstanding any act or omission on the part of any Employee in connection with any amount relating to such trading, indebtedness, or balance.

If any instrument covered under Insuring Clause (D) or (E) is involved in any trading loss, then this subsection (e) shall not be construed as excluding liability under Insuring Clause (D) or (E) on account of such instrument for the amount recoverable thereunder, but in no event for an amount in excess of the amount applicable under this bond for the payment of such loss.

This section shall hereafter be referred to as the "trading loss exclusion."

26. Trading loss coverage is obtained by placing an amount in the appropriate portion of the declarations page. Amounts must be shown before there is coverage. If no amounts are shown, there is no coverage.

27. A mutual fund is eligible to have a Brokers Blanket Bond Form 14, and such a bond is an appropriate bond to be issued to a mutual fund.

28. Brokers Blanket Bond Form 14 is the form used by INA with mutual funds and INA has issued many Brokers Blanket Bond Form 14's to mutual funds.

29. The language of INA's bonds is different from the Surety Association Bonds. However, there is no difference in effect. Only the mechanics differ in excluding losses resulting from trading.

30. Mutual funds may obtain fidelity bonds from insurance companies other than INA.

31. The underwriting manual of the Surety Association of America, revision of May 3, 1961, page FI-13(a), indicates that mutual funds may be insured under Brokers Blanket Bonds Form 12 and 14.

32. In the Surety Association rate manuals, mutual funds are considered part of the investment trust family and are eligible for the Form 14 bond. The Form 14 bond is used for investment companies industry wide.

33. The Brokers Blanket Bond was originally developed for stockbrokers, but over the years other businesses later qualified to use it.

34. Brokers Blanket Bond Form 14 broad form excludes losses resulting from trading from insuring clauses A, B, and C, and the exclusion may be removed by the payment of an additional premium.

35. Brokers Blanket Bond No. 14 limited form excludes losses sustained as a result of trading, and the purchase of trading loss coverage is not optional.

36. Under the Surety Association Brokers Blanket Bond No. 14, losses sustained as a result of trading by rider are also excluded and trading loss coverage is optional.

37. Under INA's Brokers Blanket Bond Form 14, insuring clauses B and C cover loss of property which is defined in said bonds and refers to physical property.

38. The bonds provide that it shall be deemed terminated or cancelled as to any employee as soon as the insured shall learn of any dishonest or fraudulent act on the part of such employee.

39. The bonds in question provide there shall be no liability for any loss sustained by such insured unless discovered before the time of termination.

40. Robert Hagopian was suspended by the S.E.C. effective September 17, 1970, for a period of six months from association with any broker, dealer, registered investment company or registered investment adviser, and was therefore prohibited fom associating with or acting on behalf of Meridian Capital Corporation or Meridian Investment Corporation with regard to PPF.

41. Henry Jamieson was a director of the PPF until at least December 1970.

42. Jameison was also a director of the Winfield Growth Fund at the time the 1969 prospectus was prepared, which made reference to the Hagopian suspension.

43. Jamieson was aware of the S.E.C. suspension order regarding Hagopian on September 17, 1970. Jamieson was a respondent in the same proceedings as Hagopian.

44. The Winfield Bonds provide that the insured, by acceptance of these bonds, gives notice to the underwriter terminating or cancelling prior bonds, and accordingly, terminated and cancelled the previous Bond Nos. 532268 and 532269 (the 1968 bonds).

45. Winfield Growth Fund and Winfield & Company consented to the termination and cancellation of the 1968 bonds and accepted the 1969 bonds.

46. Notice of the replacement of the 1968 bonds by the 1969 bonds was given to the S.E.C. by the filing of said 1969 bonds with the S.E.C.

47. The only difference between the 1968 bonds and the 1969 bonds with regard to the trading loss exclusion language is the addition of the phrase, "Including all transactions involving the purchase, sale or exchange of securities," which was an explanatory clarification of the word "trading." INA did not intend to make a substantial change by adding that explanatory language.

48. The change between the 1968 bond forms and the 1969 bond forms by the deletion of the words "criminal act" was not intended by INA to enlarge fidelity coverage.

49. James Wyllie drafted the 1968 revision of the INA bonds which were issued to the Winfield entities in 1969.

50. The later INA forms were taken from earlier Surety Association forms. The language contained in the trading loss exclusion in the 1969 INA bonds is similar to the language of the Surety Association form other than the additional language in the INA bond that trading included the purchase and sale or exchange of securities.

51. David H. Meid acted in a dual capacity, both as an officer and director of Winfield & Company, and as an officer of WGF. He resigned his various positions and left the manager as well as the fund in the middle of 1969.

52. WGF entered into a written contract with Winfield & Company, whereby Winfield & Company would provide among other things, investment advice and services.

53. In executing the management contract applicable to this case, Meid was acting on behalf of Winfield & Company.

54. He was chief investment officer of Winfield & Company and in that capacity was responsible for investment portfolios.

55. The New York office where A. Stephen Sanders was employed was opened for Winfield & Company and Winfield Associates. Meid had the primary responsibility for hiring of the portfolio manager.

56. In addition to obtaining bond coverage for its own purposes, the fund required pursuant to the management agreement that Winfield & Company carry fidelity insurance for the officers and employees of Winfield & Company.

57. Sanders' compensation was paid exclusively by Winfield & Company and Winfield Associates. Winfield & Company and Winfield Associates prepared W-2 forms and withheld taxes for Sanders' wages.

58. Sanders' employment records were kept by Winfield & Company.

59. WGF paid no salary to the portfolio manager.

60. Sanders was employed by the management company as a portfolio manager because WGF had a management contract with Winfield & Company.

61. Winfield Growth Fund Board hired the management company (Winfield & Company) by contract. The portfolio manager worked for the management company .

62. Sanders said he was employed by Winfield & Company.

63. Jamieson testified Sanders was hired by Winfield & Company.

64. Meid, R. Martin Wiskemann, Sanders, and possibly Donald Herman were assigned by Winfield & Company under the management contract to manage the WGF portfolio.

65. Sanders was not an officer of WGF and not paid by WGF.

66. Periodically, WGF was required by law to make reports to the S.E.C. One such report, dated June 30, 1965, represented that the fund had no employees.

67. In the N-1R Form, dated June 30, 1970, WGF informed the S.E.C. that Sanders was an officer and employee of the investment adviser, Winfield & Company, and was paid a salary by Winfield & Company. The S.E.C. was further informed by WGF that the fund had no full-time employees and no part-time employees.

68. In the telephone deposition that Jamieson gave to the S.E.C., he represented that he was chairman and president of Winfield & Company, director of Winfield Associates, and Winfield Distributors, and had Stephen Sanders working for him in New York.

69. Robert Lovejoy executed an application for Brokers Blanket Bonds in 1968 and therein represented A. Stephen Sanders to be an employee of Winfield & Company.

70. WGF minutes disclose that the Board was aware of the contents of the information on the N-1R forms before submission to the S.E.C.

71. In recording transactions made in the WGF portfolio and PPF portfolio, Winfield & Company, the portfolio manager, caused the form to be prepared. This was commonly known as a daily transaction report. It was in the nature of a letter from Winfield & Company to the appropriate fund.

72. Winfield & Company acted as manager and investment adviser and made the recommendations to the funds.

73. Winfield & Company made the decisions regarding the portfolio and they were approved by an offcer of the fund, and that is why, at the bottom of the daily transaction

reports, it shows that it is approved by Winfield & Company, and also approved by WGF.

74. WGF was aware that Sanders was an officer and employee of Winfield & Company and Winfield Associates. In a letter dated November 18, 1971, WGF by and through its counsel, Pillsbury, Madison & Sutro, made a claim against Winfield & Company and Winfield Associates. In that letter, counsel referred to the S.E.C. complaint alleging Sanders to be an officer and employee of Winfield & Company and Winfield Associates.

75. The letter further advised Winfield & Company that the Board of Directors of WGF had authorized them, as special counsel for the fund, to bring suit against Winfield & Company and Winfield Associates.

76. The Board of Directors approved the letter being sent by Pillsbury, Madison & Sutro to Winfield & Company, wherein Sanders is described as an officer and employee of Winfield & Company and Winfield Associates.

77. Mr. Aldridge, on behalf of WGF, filed a proof of loss dated February 10, 1972, with INA. In such proof of loss, which is under oath, he states therein as follows: "Sanders, who resides at 315 East 86th Street, New York, New York, was employed by the fund's investment adviser, Winfield & Company, Inc. . . ."

78. Jamieson held a dual capacity in that he was an officer and director of both Winfield & Company and Winfield Growth Fund.

79. Sanders, acting as a portfolio manager, was controlled by Jamieson in Jamieson's capacity as an officer and director of Winfield & Company.

80. The prospectus of WGF of October, 1969, states at page 10 that "Subject to the instructions of and review by the board of directors of the Fund, the officers of the Fund and manager, will determine which securities are to be purchased and sold by the Fund . . ." The telegram, Exhibit 25, is an example of the authority reserved by WGF to exercise its ultimate decision with regard to the purchase annd sale of securities.

81. In adopting the Investment Company Act of 1940, the legislative history of the Act reflects the desire of Congress to keep separate the various entities in the mutual fund family.

82. The question in S.E.C. form N-1R indicate a desire to distinguish between employees of the management company and of the fund.

83. There is no common understanding in the insurance industry or the mutual fund industry that a portfolio manager of a management company is an employee of a mutual fund.

84. PPF entered into a management agreement with Winvest Management Limited, a Canadian corporation, on December 12, 1968.

85. On December 17, 1968, Winvest Management Limited entered into a written contract with Winfield Associates, entitled Investment Advisory Agreement, whereby Winfield Associates was authorized to direct the investment of the assets of PPF in its discretion, subject only to those by-laws of the fund which may impose investment restrictions and subject to the investment policy of the fund as may be set forth in its prospectus.

86. During the period from 1969 to April, 1970, A. Stephen Sanders, as an employee of Winfield Associates, served as the sub-advisor for PPF, pursuant to the Investment Advisory Agreement between Winvest Management Limited and Winfield Associates described above. He conducted his sub-advisory activities from the offices of Winfield & Company in New York City.

87. During the period December, 1969, through at least March, 1970, John P. Galanis, in concert with others, engaged in the artificial manipulation of the public market price of various securities for his own personal profit and gain and for the personal profit and gain of his associates.

88. During the period December, 1969, through March, 1970, John P. Galanis made payments of money to Sanders in return for Sanders causing WGF and PPF to purchase some of the securities being manipulated by Galanis.

89. During the period of time during which Sanders acted as portfolio manager for WGF, Sanders had the ability to influence the makeup of WGF's portfolio and did, in fact, cause WGF to purchase various securities, including those being manipulated by Galanis as aforesaid.

90. As a sub-advisor to PPF, Sanders had the ability, subject to the by-laws of PPF which imposed investment restrictions, and subject to the investment policy of PPF as set forth in the prospectus, to influence the makeup of PPF's portfolio and did, in fact, cause PPF to purchase various securities, including those being manipulated by Galanis as aforesaid.

91. Sanders caused WGF and PPF to make purchases at Galanis' direction, with knowledge that the prices of the stocks purchased were being artificially manipulated. He did so without regard to the investment merit of the stocks. Sanders profited personally from these actions through payments made personally to him by Galanis.

92. Sanders plead guilty to counts 21 and 29 of an indictment (*USA v. Hagopian, et al.,* 72 Cr. 994, S.D.N.Y.).

93. John P. Galanis plead guilty to one or more counts of the same indictment as referred to above.

94. Plaintiff WGF contends that as a result of the activities of Mr. Sanders as described above, it has suffered losses and damages in excess of $300,000.

95. Plaintiff PPF contends that as a result of the activities of Mr. Sanders as described above, it has suffered losses and damages in excess of $2,000,000.00. PPF seeks to hold INA responsible for such losses as fidelity insurer of Winfield and Associates; third-party plaintiffs Winfield and Associates, Inc., seek indemnity from INA for any judgment against them by PPF and for costs of defense in this action and in a related S.E.C. action.

96. Pursuant to an agreement on or about September 1, 1970, Meridian Management Corporation became the investment advisor for PPF effective that date. Defendant Robert Hagopian acted for Meridian as sub-advisor to PPF.

97. During the period September, 1970, through December, 1970, John P. Galanis made payments of money to Hagopian in return for Hagopian causing PPF to purchase and sell stocks which Galanis was manipulating.

98. Hagopian caused PPF to make purchases and sell stocks at Galanis' direction with knowledge that the price of the stocks was being artificially manipulated and without regard to the investment merit of the stocks, and in order to profit personally through payments made to him by Galanis.

99. Hagopian plead guilty to certain counts of an indictment (*USA v. Hagopian, et al.,* 72 Cr. 884, S.D.N.Y.).

100. Plaintiff PPF contends that as a result of the activities of Hagopian as described above, it has suffered losses and damages in excess of $500,000.00.

101. In the relevant period, in addition to the management contract heretofore referred to, WGF had a custodian agreement with the City National Bank and Trust Company of Kansas City, Missouri, ("City Bank") and an underwriting agreement with Winfield Underwriters, Inc., a wholly-owned subsidiary of Meyerson & Company, a local San Francisco stockbroker.

102. PPF was not going to be registered in the United States as far as being registered to sell shares.

103. Lovejoy first discussed the bonds with Mark Hopkins some time in 1964 or 1965.

104. Lovejoy discussed coverage at least annually or perhaps even semi-annually with Hopkins beginning in 1965.

105. All of his discussions were with Hopkins. He never contacted INA.

106. He got advice on the bonds from Hopkins and from Stradley, Ronon, Stevens, & Young, attorneys for WGF.

107. Hopkins was never at WGF's board meetings.

108. In February, 1965, WGF's counsel notified the Fund of a S.E.C. amendment to Rule 17g-1 regarding cancellation clauses and sent WGF a copy of a new cancellation rider.

109. Hopkins received the February, 1965, memo, including the cancellation rider, from Lovejoy. Lovejoy instructed him to have the cancellation rider attached to the bonds and Hopkins told Lovejoy that he would do so. Lovejoy had told him both in writing and in person in his office that the S.E.C. rules required that the rider be attached.

110. On April 27, 1965, Hopkins mailed a photocopy of the S.E.C. cancellation rider to INA. Hopkins stated therein "Attached is a photocopy of a rider which should be attached to the renewal bond. This rider has been worked out by the Surety Association of America to comply with the Securities and Exchange Commission Rule 17g-1. Please see that it is attached."

111. Hopkins merely did what Winfield wanted done in connection with the bonds, and it was his understanding that by putting a cancellation rider on the bond it took care of whatever requirements were necessary.

112. In a letter dated July 1, 1965, Hopkins wrote to Lovejoy enclosing the cancellation clause rider to be attached to the blanket bonds. The letter states: "This coverage was included in the renewal bonds and in the premium." Hopkins testified that "this coverage" refers to the S.E.C. cancellation rider.

113. Wyllie knew that the Winfield entities required a bond partly to comply with S.E.C. Rule 17g-1 and partly for other business purposes. It was up to the insured to ask for the coverage it wanted.

114. INA could not make the determination on the coverage WGF should have obtained in order to comply with Rule 17g-1. That Rule requires the board of directors of the mutual fund to make the determination as to coverage and amount subject to a review by the S.E.C.

115. WGF did in fact exercise its independent judgment as to the amounts and coverage to be purchased under the bonds.

116. WGF's board relied upon the advice of their own counsel to determine the adequacy of the bonds in compliance with S.E.C. requirements.

117. Lovejoy had discussions with the board of WGF regarding the bonds not less than annually. He would review the bond coverage then in effect and ask the board to make a determination as to its adequacy.

118. William Courtley was an officer of WGF and was also an attorney admitted to practice before the Oklahoma bar.

119. His duties included compliance with S.E.C. regulations.

120. Courtley participated in review of the fidelity bonds on an annual basis as secretary of WGF beginning in August of 1968.

121. One of his duties was to try and follow the S.E.C. rules and regulations.

122. Courtley read the bonds as well as the exclusions and declarations sheet before going to the board of WGF for its review.

123. Courtley appeared before the board of directors of WGF and there were discussions concerning the adequacy of the fiidelity bond coverage.

124. There were discussions concerning bonding requirements every time the bond renewal came up. The board was always concerned with the size of the bond.

125. It was normal to discuss with their general counsel, Stradley, Ronon, etc., the items which were coming up on the agenda before the WGF board.

126. WGF's counsel were well aware of what coverage WGF had in their bonds.

127. Courtley talked to the Stradley office on the telephone almost on a daily basis and there were probably discussions concerning the fidelity bonds.

128. Lovejoy testified the attorneys appeared at times when bond coverage was discussed and covered with them the Rule 17g-1 requirements.

129. The directors solicited the opinions of Phillip Fina (member of the law firm of Stradley, Ronon, etc.) as to the adequacy of the bonds and compliance with S.E.C. requirements.

130. Frank Adams, an attorney and a WGF board member, felt that Fina was very qualified in S.E.C. matters.

131. The board had no communications with Hopkins or INA. They relied solely upon the advice of Courtley and their attorneys with regard to the interpretation and adequacy of the bonds.

132. Frank Abbott, a WGF board member, was aware that at least on the excess bond there was a limited form of coverage.

133. He did not discuss the question of dishonestly induced portfolio transactions with the board.

134. WGF made the decisions as to the amount of coverage they desired.

135. In purchasing bond coverage, WGF would seek cost quotations for various combinations of coverage and would make its decisions based upon these costs.

136. Hopkins testified trading loss coverage was discussed with the various and successive representatives of WGF.

137. Trading loss coverage was available.

138. Hopkins asked INA for quotes on trading loss coverage and obtained the same.

139. When Hopkins reviewed the insurance coverage with WGF, he asked them whether they wished to purchase trading loss coverage and they rejected the same.

140. The additional premium for trading loss coverage is 35% to 50% over the basic cost.

141. Hopkins talked to Lovejoy at least annually regarding the trading loss exclusion, and Lovejoy indicated that he did not want to pay the additional premiums to delete the exclusion.

142. It was always the Winfield entities' decision which coverage to purchase, not Hopkins' decision.

143. With reference to misplacement or mysterious unexplainable coverage under Insuring Clause (B), Winfield exercised its discretion to take the full amount of that coverage in the broad form bond, to-wit, $200,000, but with regard to securities forgery, Insuring Clause (E), it limited its coverage to only $25,000. Winfield could have purchased the full $200,000 coverage if it so desired. INA would have provided the same.

144. Correspondence between Hopkins and Winfield & Co. made reference to the fact that Winfield & Co. had no coverage on trading losses.

145. WGF and Winfield & Co. were aware that they did not purchase trading loss coverage.

146. There were occasions when Hopkins told Winfield certain forms of insurance were available, but they rejected it. Coate made the decision not to remove the exclusion. Hopkins talked about the trading loss exclusion with Lovejoy, Coate, and Jack Deignan at least annually, and they were aware that they did not have trading loss coverage.

147. With regard to Exhibit BN, Hopkins prepared the agenda of items to discuss with Winfield representatives with regard to bond coverage. On that exhibit, following the words "trading loss" appears the word "no". That word was inserted during Hopkins' discussion with the Winfield representatives who indicated to him that they did not want trading loss coverage.

148. The memoranda entitled Exhibit BN was probably written immediately before April 25, 1968, in that Exhibit BF, a letter from Hopkins to INA dated April 25, 1968, requests a quotation for $1,000,000 and $1,500,000, the quotations noted on Exhibit BN.

149. Deignan took over all insurance matters from Lovejoy in February, 1969, for WGF.

150. On January 10, 1969, WGF was aware that it had no trading loss coverage.

151. INA issued an interoffice memorandum on May 29, 1968, setting forth the differences between the old form bond and the new form bond.

152. An examination of that memorandum, Exhibit 43, demonstrates that the added words in the trading loss exclusion were to clarify and describe the kinds of transactions included in the term "trading".

153. The June 26, 1968, memorandum from Mitchell to Hopkins indicates that the INA interoffice memorandum which outlines the changes in the bond form was delivered to Hopkins. Hopkins should have known at that time that trading included purchase, sale or exchange of securities.

154. Exhibit 43, the INA memo, regarding the changes in the bond form, demonstrates that it was never INA's intention to cover losses resulting from violation of statutes regulating securities transactions unless the acts committed involved dishonest or fraudulent conduct. The change in the bond form by the addition of Exclusion H was only to clarify the intent of INA.

155. When the new bonds in question were obtained in 1969 there was no change in the premium charge.

156. The term "property" is defined in the bond and the term "employee" is defined in the bond. The term "trading" is also defined in the 1969 bond.

157. Questions 11 and 12 on the bond application (Exhibit I) had to be answered whether or not the insured wanted trading coverage and did not imply to Wyllie that Winfield desired trading coverage.

158. It was not Hopkins' intention to request trading loss coverage by answering Questions 11 and 12 on the bond application.

159. WGF is the only entity on the Winfield Bonds which has to be bonded under Rule 17g-1.

160. A copy of WGF's bond was filed with the S.E.C. This was done by Courtley, or through their attorneys, Stradley, Ronon.

161. INA has issued Broker's Blanket Bonds Form 14 to many mutual funds.

162. Some of the mutual funds bonded by INA obtained fraudulent trading coverage.

163. The S.E.C. never complained concerning the adequacy of the Winfield Bonds.

164. In his 15 years with INA, the S.E.C. never advised Wyllie that INA's bonds did not comply with Rule 17g-1.

165. The S.E.C. never gave appropriate notice or conducted a hearing with regard to the inadequacy under Rule 17g-1 of the Winfield Bonds issued by INA.

166. At a special meeting of the board of directors of WGF held on September 11, 1968, consideration was given to the adequacy of the fidelity bond coverage maintained by the Fund. It was reported that a stockbrokers blanket bond with a broad coverage of $200,000 and an additional limited form of stockbrokers blanket bond providing an additional $1.3 million in fidelity coverage were maintained by the Fund. The board determined that this, in addition to the fidelity coverage maintained by the Fund's custodian bank, was adequate coverage with due consideration being given to the value of the aggregate assets to which any officer or employee might have access.

167. At a regular meeting of the board of directors of WGF held on September 11, 1969, consideration was given to the adequacy of the fidelity bond coverage maintained by the Fund. It was reported that a stockbrokers blanket bond with a broad coverage of $200,000 and an additional limited form of stockbrokers blanket bond providing an additional $1.8 million in fidelity coverage were maintained. The directors determined that this coverage, in addition to fidelity coverage maintained by the Fund's custodian bank, represented adequate coverage with due consideration being given to the value of the aggregate assets to which any officer or employee might have access.

168. The trading loss exclusion is a fidelity exclusion involving the purchase or sale of securities in which the dishonest act of an employee of the insured is involved. Under those circumstances the exclusion applies.

169. The September, 1970, revision of the Surety Association Form 14 Brokers Blanket Bond excepts from the exclusion dishonest acts of employees. Unless an additional premium is paid the bond is issued with a rider deleting the exception to the exclusion and the result is that there is no trading loss coverage where employee dishonesty is involved.

170. In the INA Form 14 Brokers Blanket Bond, the trading loss exclusion excludes all trading losses including those involving employee dishonesty. In the event that trading loss coverage is desired, a dollar amount is inserted in the appropriate sublimit on the declaration sheet, which has the effect of inserting an exception to the exclusion for instances of employee dishonesty.

171. Fitzgerald testified that he is familiar with the INA bond and the INA trading loss exclusion is not inconsistent with the Surety Association exclusion. It was the common understanding in the insurance industry that trading included the buying and selling of securities.

172. It is a common understanding in the insurance industry that trading within the stockbrokers' blanket bond (Surety Association form) pertains to any purchase or sale of securities.

173. The Surety Association did not undertake to define trading because any effort to define such term would have a limiting effect, and it was intended not to be so limited.

174. The Surety Association of America was formed in 1908. In 1969 there were three classes of members in the Association; subscribers, manual purchasers, and members. INA was a manual purchaser back in 1968-1969, and in that capacity exchanged information with the Association.

175. Fitzgerald was very active in the drafting of the various Surety Association form bonds and the negotiations with industry representatives. He was particularly inter-

ested in Form 12 and Form 14 Stockbrokers Blanket Bonds, from the beginning of his employment.

176. Pake FI-66 of the underwriting manual of the Surety Association of America, revision of September 30, 1970, indicates that trading coverage is optional. Such coverage is included in Form 14 and may be either limited or deleted.

177. In the Surety Association underwriting manual (revision of September 30, 1970), at page FI-6, mutual funds are indicated under the caption, "Who may be insured under a Form 14 Bond".

178. The turnover rate is a relative factor to be considered in determining whether an institutional investor is trading according to the testimony of plaintiffs' own expert.

179. With reference to the PPF prospectus, it was Sanders' understanding that the shares were going to be of a speculative nature.

180. The PPF prospectus states: "The rate of portfolio turnover is not treated as a limiting or relevant factor when circumstances exist which are considered by management to make portfolio changes advisable. The fund's objective of capital growth will involve a portfolio turnover substantially greater than that of other investment companies..."

181. The WGF represented in its prospectus that "it is probable that in carrying out the investment program outlined under 'policies and objectives' the fund will be more active in the buying and selling of securities than the average mutual fund and the rate for the past three fiscal years has been higher than those typical of other 'growth' funds."

182. In its prospectus dated December 15, 1969, WGF stated: "Fund expects that its annual portfolio turnover rate will exceed 100% as it has for the past three years."

183. The rates of turnover for WGF for the years 1967, 1968, and 1969, are demonstrated in its report to the S.E.C.

entitled "N-1R, June 30, 1969". At page 9 thereof the common equity portfolio turnover for 1969 was 202%, for 1968, 235%, for 1967, 235%.

184. The prospectus for WGF further provided: "Moreover, the Fund and its adviser, will not treat the rate of portfolio turnover as a limiting or relevant factor when circumstances exist which make portfolio changes advisable."

185. WGF recognized that it was trading.

186. The trading department of Winfield & Co. maintained a "Performance Plus Trading Book" covering the period of January 20, 1969, to August 31, 1970. That book indicated that Winfield & Co. made entries therein when there were no transactions for a particular day as "no trading".

187. Wiskemann explained such entry by testifying that the word "trading" means a way of investing.

188. Every stock transaction is a trade.

189. An employee of the management company, called a trader, would call the broker and purchase securities.

190. The person at the management company who worked with specific brokers regarding stock transactions was known as the chief trader.

191. The trader is employed by Winfield & Co. The trader would follow its instructions to make a trade.

192. The directors of Winfield & Co. were aware that the purchase and sale of securities constituted trading. See Exhibit BR, page 2, wherein the minutes state: "The chairman then stated that it would be in order to set up some guidelines regarding trading orders that were received in the Wincap and Winfield Growth Funds." The resolution that follows therein also refers to "trading orders in the Wincap and Winfield Growth Funds."

193. Jamieson, the Chief Executive Officer of Winfield & Co. and Winfield Growth Fund understood that they were trading. Jamieson testified that he told the S.E.C. in his telephonic deposition that "all trades were executed in San Francisco including the trades in New York City."

194. He further testified it is common for the Board of Directors of Winfield Growth Fund to use the terminology "trading".

195. He further testified as far as Winfield Growth Fund was concerned, all "trading" was done in San Francisco.

196. When Sanders recommended the purchase or sale of securities, he or someone in his office would call the trading department in San Francisco. This activity is known as a "trade".

197. As a result of the conduct of Sanders, the directors thought it would be in the best interest of the company to set up a system of checks and controls to regulate all trading procedures. In the minutes, the very term "trading procedures" is used. Thereafter, in a resolution unanimously passed, it was resolved to appoint a committee on procedures to regulate the "trading activities" of the company. The words "trading activities" is used in the resolution.

198. It was the custom of Winfield & Co. to have staff meetings. In the following meetings, the following discussions were had concerning securities transactions.

(a) February 12, 1969, the minutes indicate Meid was in the process of interviewing someone for the job of a trader.

(b) February 19, 1969, the minutes indicate Meid had hired someone for the position of trader.

(c) February 19, 1969, minutes indicate that "all trades for all funds must be done (on the advice of their lawyers) from San Francisco".

(d) February 26, 1969, minutes indicate that a trader had been hired.

(e) March 26, 1969, minutes indicate that the trader would have to become an officer of Winfield Growth Fund. Those minutes further indicate "trading" forms being used in the trading department to indicate the trade and which company the trade is being made for. Some question was raised as to whether the trader would have to be licensed as a registered representative.

(f) May 7, 1969, minutes indicate that "all trading will be done through this office as of Monday, May 12. All correspondence concerning trading transactions will be forwarded to this office from New York City."

199. A member of the Board of Directors of the WGF testified "they have a trader who executes purchases and sales."

200. Finally, Diegnan testified that WGF used the term "trading" for the purpose of describing the purchase and sale of securities.

201. Trading in the broadest sense is buying and selling of securities.

202. Other mutual funds trade as demonstrated by the Pace Fund prospectus, wherein it states, "it is expected that the securities of many of such companies will be traded only in the over-the-counter markets.

203. The S.E.C. ascertained that mutual funds engaged in trading. In its report to Congress, the S.E.C. stated, "Although mutual funds that emphasize speculative trading policies do not represent a large segment of the industry, there has been a tendency for managers of other funds to emphasize more active trading in order to capitalize on the short-term market movements. This tendency is re-

flected in a rise in aggregate mutual fund portfolio turnover rates in late 1965 and the first half of 1966."

204. Congress has recognized that mutual funds trade. In the Investment Company Act of 1940, the findings and declaration of policy state in part as follows: "The principal activities of such companies—investing, reinvesting and trading in securities—are conducted by the use of mails. . ." "Such companies customarily invest and trade in securities—".

205. There is a common understanding in the mutual fund industry that mutual funds engage in trading. There is a common understanding in the mutual fund industry that the term "trading" means the same as is used in the securities industry generally. Trading is effecting the purchase and sale of securities, and anything involved in the trading process would be trading, including the acts of Sanders.

206. Under a hypothetical set of facts identical to the facts involved in this case, it was the opinion of Mr. Fitzgerald that Sanders was involved in trading. The basis of his opinion is that anyone who is at all involved in the purchase and sale of securities would be involved in trading.

207. Under a hypothetical set of facts identical to those in the instant case, both Winfield & Co. and Winfield Growth Fund were trading.

208. There is no common understanding in the insurance brokerage industry that the trading loss exclusion applies only to those insureds having customers accounts. The common understanding in the industry is that the trading loss exclusion applies to all insureds eligible for this type of bond.

209. The bonds provided by INA cover many losses that might be sustained by the various insureds under its bonds. The bonds were issued to insure not only WGF but nu-

merous insureds which might sustain losses that would be covered by the bonds in question. Although no trading loss coverage was purchased by the fund, there was exposure and risks which would be covered under the bonds in question.

(a) No reference herein will be made to any custodian agreement arrangement by PPF since they are not an insured under the bonds.

(b) With reference to WGF, the City National Bank and Trust Company of Kansas City acted as custodian for securities and cash of that fund. The custodian played no part in decisions relating to the purchase or sale of portfolio securities.

(c) Proper instructions in the custodian agreement occurred when two appropriate officers sign such instructions to the custodian bank. The bank merely does as it is directed to do in those instructions.

(d) Under the custodian agreement involved in this case, the custodian bank would follow "proper instructions".

(e) One risk of loss is a fraudulent scheme involving collusion between the fund's officers and the custodian bank personnel, and such a risk would be covered under Form 14 bond which is not excluded by a trading loss exclusion.

(f) There would be coverage under INA's bonds if the securities were lost or destroyed, notwithstanding the custodian bank's coverage.

(g) Physical loss of securities while in transit per messenger is covered.

(h) Another risk of loss would be where the custodian bank was ordered to pay out fictitious or padded expenses. It is not the function of the custodian bank to pass upon the validity of expenses. They merely follow duly issued instructions of the fund.

(i) Another example of loss covered by the bond is where an affiliated company, such as Applied Financial in this case, conspires with officers of the fund.

(j) Another risk of loss is in a short position where there is leverage and there is borrowing on pledged assets. Under those circumstances securities may not be held by the custodian bank and fraudulent means could be devised to cause losses to the fund.

(k) Another possible risk of loss is where the bank follows or negligently ignores proper instructions and permits the fund's officers to commit criminal acts in obtaining securities or money.

(l) Winfield Growth Fund permitted due bills to be used in lieu of receipt of securities when the securities could not be obtained by the custodian bank within five working days. The bank would distribute cash but receive due bills in lieu of securities. Instructions would be sent to the bank regarding due bills.

(m) A substantial risk of loss could be incurred by the fund in the use of due bills in the event of fraudulent or dishonest nondelivery of the securities.

(n) Winfield Growth Fund did engage in sales of large blocks of securities. On May 11, 1970, for example, the daily transaction report indicates that 216,200 shares of Neonex was sold.

(o) Winfield & Co. had no direct access to the fund's assets, but there was the possibility of false instructions to the custodian.

(p) The officers of the fund signed vouchers directing the bank to pay out cash for the payment of expenses.

(q) Such acts could be dishonestly done.

(r) Another risk of loss covered under the bonds was the fund's cash assets in a bank account which was not deposited with the custodian bank as early as June, 1970, for the purpose of redemption and liquidation. Such account could have $500,000 in it.

(s) Winfield & Co. had bank accounts, as did the underwriter.

(t) Winfield & Co. maintained such bank accounts throughout 1967, 1968, 1969, and 1970, with balances going up to $470,000.

(u) Winfield & Co.'s bank account in 1969 had been up to as high as $470,000.

210. Exhibit 67 is entitled "Agency Agreement" and is signed by Mark Hopkins. However, such agreement gives the authority to Hopkins to do only the following things:

(a) To receive and accept proposals;

(b) To collect, receive and receipt for premiums;

(c) To retain his commission out of premiums collected.

211. The issuance of these fidelity bonds is commonly referred to as a "centralized risk" and the authority to issue these bonds rests with the home office alone.

212. The INA service office in San Jose had no authority to underwrite these bonds but could only collect the information and submit it to the home office.

213. Wyllie handled centralized risks. This requirement was in effect with reference to the bonds in this case in 1968.

214. The San Jose office of INA did not have authority to underwrite these bonds on its own, but was required to contact the home office for underwriting instructions and prices for coverage.

215. Information regarding a Brokers Blanket Bond was submitted by producers to the underwriter and includes an application and perhaps supplementary material. The premiums are prepared locally, and the application, supplementary material, and premium calculation is submitted for approval to the territorial underwriter.

216. In connection with the present bonds, the producer was not responsible to review and act upon the application. It was only his responsibility to see that the application was signed and forwarded to the home office.

217. Hopkins had no authority to underwrite the bonds in this case.

218. At no time did Hopkins have authority to bind INA or make representations on behalf of INA in connection with these fidelity bonds.

219. There is a common understanding in the insurance industry that the decision to underwrite fidelity bonds rests only with the underwriter.

220. Hopkins was a licensed broker.

221. Throughout his dealings with the Winfield entities, Hopkins referred to them as his "clients".

222. The bonds sued upon herein were signed only by employees of INA.

223. With reference to Exhibits 11 and 12, they too were executed by employees of INA, except that Hopkins testified that change of name endorsements were signed by his office. Hopkins testified that this was probably a correction of an error.

224. All of the correspondence in this case shown to Lovejoy refers to Hopkins as a broker.

225. Lovejoy received no literature describing Hopkins as an agent, but only as a broker.

226. In the relationship between INA and the Winfield entities, Hopkins represented the interests of the Winfield entities. When there was a dispute whether the new form bond or old form bond should be issued in 1968, Hopkins' employee told INA "in no uncertain terms" that they wished to have the old form bond.

227. As a result of Hopkins' objection to the new form bond, INA agreed to go along with the old form bond for one year.

228. Hopkins ratified the conduct of Mitchell in telling INA that the 1968 bonds would have to be written on the old form. Mitchell was acting within the scope of his employment in making those comments.

229. An employee of Hopkins wrote to Hopkins in a memo that "This means that next year the new bond form will have to be used if we are to stick with the INA. Due to the effective date of this bond, it looks like we are stuck doing it this way, however, Ted has indicated that if we at any time choose to cancel this bond and replace it with another company, a pro rata cancellation will be granted."

230. In a letter dated July 11, 1968, from Hopkins to Lovejoy, Hopkins refers to the Winfield entities and himself as "we", in stating "we must pay the company".

231. Hopkins advised Lovejoy that the old form bond would be issued for one year only, and Lovejoy consented to such fact.

232. Any finding of fact more properly deemed a conclusion of law shall be considered a conclusion of law.

Conclusions of Law

1. The Court has jurisdiction in action C-74-1174 under 28 U.S.C. § 1332 and venue is properly laid in this District under 28 U.S.C. §§ 1391(a), (c). Said action is a proper action for declaratory relief under 28 U.S.C. § 2201 in that

an actual controversy exists between Winfield Growth Fund and defendant Insurance Company of North America involving their respective rights and liabilities under the Winfield Bonds.

2. The Court has jurisdiction over Performance Plus Fund's action against defendant Insurance Company of North America in action C-73-2178 under 28 U.S.C. § 1332. Venue is properly laid in this District under 28 U.S.C. §§ 1391(a), (c). The Court has jurisdiction of the cross-claims of Winfield & Co., Inc. and Winfield Associates, Inc. against Insurance Company of North America in action C-73-2178 because of jurisdiction over the primary claims against the cross-claimants and Rule 13(g), Federal Rules of Civil Procedure.

3. A. Stephen Sanders was an officer and employee of Winfield & Co., Inc. and Winfield Associates, Inc.

4. Under California law, for purposes of determining liability for tortious actions, an individual may be considered an employee of both a special and general employer. *Strait v. Hale Construction Co.*, 26 Cal.App.3d 941, 103 Cal. Rptr. 487 (1972). The public policy considerations underlying the determination of the proper allocation of risk that lie behind this conclusion include the ability of a special employer to insure against the risks involved in the particular activity that gave rise to the claim for liability. Despite the parties' attempt to fit this case into the conceptual framework of the general-special employer problem, such an approach is not appropriate. While under that approach, it may be concluded that Sanders was also an employee of Winfield Growth Fund in that the Fund could properly be held accountable to anticipate the need to obtain insurance covering the actions of Sanders pertinent to this case, such a determination begs the question of whether the Fund in fact did obtain such insurance coverage.

5. Considering all the circumstances of this case, including the definition of "employee" in the bonds, the Fund's

representations to the S.E.C., and the Fund's representations to INA, A. Stephen Sanders was not an officer or employee of the Winfield Growth Fund for the purposes of coverage under the Winfield Bonds.

6. Sanders was not an officer or employee of the Performance Plus Fund.

7. Robert Hagopian was an employee of Meridian Management Corporation.

8. The trading loss exclusion contained in INA's bonds limits fidelity coverage under Insuring Clause A.

9. The meanings of "trading" and the trading loss exclusion in the bonds are not ambiguous and uncertain.

10. The losses claimed or anticipated by Winfield Growth Fund, Performance Plus Fund, Winfield & Co., Inc., and Winfield Associates, Inc. arising from the activities of Sanders and Hagopian pertinent to these lawsuits arose, directly or indirectly, from trading within the terms of the trading loss exclusion clause of the bonds.

11. Mark Hopkins, Inc. under the facts of this case was acting as a broker on behalf of the Winfield entities and not as an agent for INA.

12. The trading loss exclusion does not render INA's bonds illusory to the Winfield entities and the Meridian entities named as insureds on the bonds.

13. The insureds had no reasonable expectation that the losses of the character sustained by them in this case would be covered under INA's bonds.

14. With respect to the Winfield Bonds, it was reasonable for Winfield Growth Fund to expect that the bonds satisfied the requirements of S.E.C. Rule 17g-1.

15. With respect to Winfield Growth Fund, the Winfield Bonds were statutory bonds as required by Rule 17g-1.

16. No other insured on any of the bonds had a reasonable expectation that the bonds satisfied any requirement under Rule 17g-1 and none of the bonds are statutory bonds for any of the insureds other than Winfield Growth Fund.

17. Rule 17g-1, 17 C.F.R. § 270.17g-1, requiring registered management investment companies to maintain fidelity bonds was enacted pursuant to Section 17(g) of the Investment Company Act of 1940, 15 U.S.C. § 80a-17(g), which authorized such a rule to cover employees of registered management investment companies. Congress was aware of the differences and interrelationships between management investment companies and investment advisers. It also authorized the S.E.C., under the Investment Company Act of 1940, to adopt rules to prevent fraudulent, deceptive, or manipulative practices on the part of certain persons connected with investment advisers, 15 U.S.C. § 80a-17(j). Section 17(g) of the Act, however, does not mention investment advisers.

Paragraph (b) of Rule 17g-1 provides that three types of bonds satisfy the Rule. One type, a "joint insured bond", can include "persons engaged in the management" of a registered management investment company as insureds on the bond. These persons would include investment advisors who have management contracts with a registered management investment company. They are not "covered persons" within the terms of paragraph (a) of Rule 17g-1. Coverage of these persons is optional, and lack of such coverage does not affect the adequacy of the bond for purposes of Rule 17g-1. "The use of joint insured bonds by investment companies is permissive rather than mandatory." 39 Federal Register 10578 (March 21, 1974).

Consequently, employees of investment advisers who render services to registered management investment companies are not "employees" or "covered persons" within the meaning of Rule 17g-1(a).

18. As statutory bonds with respect to Winfield Growth Fund, the Winfield Bonds have to be interpreted in light of Rule 17g-1. Even assuming, however, that Rule 17g-1 would consider Sanders to be an "employee" of Winfield Growth Fund and a "covered person", and assuming further that the losses claimed by Winfield Growth Fund come under the terms "larceny and embezzlement", the bonds cannot be read as providing the coverage claimed by Winfield Growth Fund. Despite the statutory bond situation, considering Sanders to be an employee of Winfield Growth Fund and considering the trading loss exclusion to be inapplicable to the claimed losses would be "necessarily and absolutely inconsistent with the unequivocal intent of the parties as disclosed by the express terms of the bond itself." *Milliron v. Dittman,* 180 Cal. 443, 446 (1919).

19. These bonds are not adhesion contracts.

20. The bonds are for the benefit of the named insureds only and are not for the benefit of third parties.

21. Exclusion 1(h) does not apply in these cases.

22. Any conclusion of law herein properly deemed a finding of fact shall be considered a finding of fact.

23. Defendant INA is entitled to dismissal of the eleventh and twelfth claims for relief in the complaint of Performance Plus Fund in C-73-2178.

24. The cross-claims of Winfield Associates, Inc. and Winfield & Co., Inc. in C-73-2178 against INA should be dismissed.

25. INA is entitled to judgment against Research Equity Fund dismissing action C-74-1174 with prejudice and with costs.

DATED: December 16th, 1976.

/s/ ALBERT C. WOLLENBERG
Albert C. Wollenberg
United States District Judge

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

No. C-73-2178

PERFORMANCE PLUS FUND, LTD., *Plaintiff,*

vs.

WINFIELD & CO., INC., et al.,
Defendants and Third Party Plaintiffs,

vs.

MARK F. HOPKINS & CO., INSURANCE BROKERS, INC.,
a corporation, et al., *Third-Party Defendants.*

ORDER PARTIALLY DISMISSING COMPLAINT AND DISMISSING CROSS-CLAIMS AGAINST DEFENDANT INSURANCE COMPANY OF NORTH AMERICA

Original Filed December 16, 1976

This action having come on for trial before the Court, Honorable Albert C. Wollenberg, District Judge, presiding without a jury, a jury having been expressly waived, the issues having been duly presented by the parties, findings of fact and conclusions of law having been entered, and a decision having been duly rendered,

IT IS HEREBY ORDERED that the eleventh and twelfth claims for relief in the complaint of Performance Plus Fund Ltd. are DISMISSED.

IT IS FURTHER ORDERED that the cross-claims of Winfield Associates, Inc. and Winfield & Co., Inc. against Insurance Company of North America are DISMISSED.

DATED: December 16th, 1976.

/s/ ALBERT C. WOLLENBERG
Albert C. Wollenberg
United States District Judge

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

No. C-74-1174

RESEARCH EQUITY FUND, INC., *Plaintiff,*

vs.

THE INSURANCE COMPANY OF NORTH AMERICA, *Defendant.*

JUDGMENT

This action came on for trial before the Court, Honorable Albert C. Wollenberg, District Judge, presiding without a jury, a jury having been expressly waived, the issues having been duly presented by the parties, findings of fact and conclusions of law having been entered, and a decision having been duly rendered,

IT IS HEREBY ORDERED AND ADJUDGED that the plaintiff take nothing, that the action be DISMISSED on the merits, and that the defendant recover of the plaintiff its costs of action:

DATED: December 16th, 1976.

/s/ ALBERT C. WOLLENBERG
Albert C. Wollenberg
United States District Judge

ENTERED IN CIVIL DOCKET 12/17/1976.

NOTICE: In accordance with LR 124 (c) costs will be based in accordance with the bill of costs unless objections are filed.

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 77-1467

DC CV 74-1174 ACW

RESEARCH EQUITY FUND, INC., *Appellant,*

vs.

THE INSURANCE COMPANY OF NORTH AMERICA, *Appellee.*

JUDGMENT

APPEAL from the United States District Court for the Northern District of California.

THIS CAUSE came on to be heard on the Transcript of the Record from the United States District Court for the Northern District of California and was duly submitted.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court, that the judgment of the said District Court in this Cause be, and hereby is affirmed.

Filed and entered May 31, 1979.

A True Copy Attest 24 September 1979.

EMIL E. MELFI, JR.
Clerk of Court

/s/ by: OSCAR LAGLE
Deputy Clerk

This certification *does not* constitute the mandate of the Court.

APPENDIX D

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 77-1467

RESEARCH EQUITY FUND, INC., *Appellant,*

v.

THE INSURANCE COMPANY OF NORTH AMERICA, *Appellee.*

FILED July 11, 1979

EMIL E. MELFI, JR., Clerk
U.S. Court of Appeals

ORDER DENYING REHEARING

Before: WRIGHT and KILKENNY, Circuit Judges, and PFAELZER, District Judge.

Appellant's Petition for Rehearing, filed on June 14, 1979, has been considered by the panel and is denied.

In the Supreme Court

OF THE

United States

October Term, 1979

No. 79-584

Research Equity Fund, Inc.,
Petitioner,

vs.

The Insurance Company of North America,
Respondent.

RESPONDENT'S BRIEF OPPOSING PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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SUBJECT INDEX

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QUESTION PRESENTED

INA respectfully submits that no question is presented, either in WGF's petition, the amicus curiae brief of the Investment Company Institute, or on the merits of the case, which requires review by this Court.

STATEMENT OF FACTS

This is an action brought by Research Equity Fund, Inc., successor by merger of Winfield Growth Fund, Inc., hereinafter called "WGF." (CT 352)[1] WGF was a pub-

[1]The abbreviation "CT" refers to the Clerk's Record, while "RT" refers to the Reporter's Transcript.

licly held, open end, diversified registered management investment company under the Investment Company Act of 1940, commonly known as a "mutual fund." (CT 352). It brought this action against Insurance Company of North America, hereinafter referred to as "INA" for declaratory relief and money damages. WGF alleged that it had sustained losses as a result of portfolio transactions and that such losses were covered by the fidelity bonds issued by INA. (CT 295). Said bonds were joint insured bonds issued on or about June 15, 1969, which remained in force until June 15, 1972. One of the joint insureds was WGF. (Ex. 8, 9, CT 352).

At the time said bonds were executed, Section 17(g) of the Investment Company Act of 1940, hereinafter referred to as Sec. 17(g) and Rule 17g-1, hereinafter referred to as Rule 17g-1[2] required WGF as a Registered Management Investment Company to provide and maintain a bond against larceny and embezzlement covering each of its officers and employees who may singly, or jointly with others, have access to securities or funds of WGF, either directly or through authority to draw upon such funds or to direct generally the disposition of such securities. (CT 352).

Winfield & Co. was an investment adviser and managed several funds, one of which was WGF. (RT 823-824). WGF, being a mutual fund, its prinpical business was the purchase, sale and exchange of securities. (Ex. 6, pp. 1-2).

[2]Unless otherwise indicated, "Sec." refers to the Investment Company Act of 1940, 15 U.S.C. Section 80a-1, *et seq*. "Rule" refers to the S.E.C. Rules and Regulations thereunder, 17 C.F.R. Section 270, *et seq*.

On or about December 31, 1968, WGF entered into a written contract with Winfield & Co., whereby Winfield & Co. was employed by WGF as its investment adviser and would provide, among other things, investment advice and management of WGF's portfolio of securities. (Ex. 3). David Meid, R. Martin Wiskemann, Donald Hermann, and A. Stephen Sanders were employees of Winfield & Co. and assigned to manage various portfolios, including that of WGF. (RT 1597-1598, Ex. B).

Sanders was neither an officer nor an employee of WGF, but was employed by Winfield & Co. from March 1, 1968, until April 30, 1970 (F.F. 60 and 65; Ex. C). Sanders and Hermann were assigned by Winfield & Co. to their New York offices and their superior, Meid, was the chief portfolio officer and president of Winfield & Co. (RT 1550-1552, Ex. 63, p. 14). Meid terminated his position in September of 1969 and Wiskemann became Sanders' superior. (RT 402). Wiskemann was Vice President and, on occasion, Treasurer and Secretary of Winfield & Co., and also Director of Research. (RT 397-398, Ex. 4, p. 3).

Although all of the officers of WGF were also officers of Winfield & Co., the contrary was not true in that Sanders, an employee of Winfield & Co., was not an officer or employee of WGF. (Ex. 4, pp. 3-4; Ex. 6, pp. 3-4; Ex. 63, pp. 11-12; RT 1536-1540).

Sanders would make his recommendations to his superior, either Meid or Wiskemann. (RT 824-827). There was daily telephone communication between Meid and Sanders and, although not daily, a great deal of telephonic communication between Sanders and Wiskemann. (RT 1553,

402). The recommendations of Sanders (as well as others) would be recorded on a daily transaction report and such reports indicate that Sanders' recommendations required the approval of his superior at Winfield & Co. (RT 824, 828-829). The recommendation would then be forwarded to WGF and upon approval by an appropriate officer of WGF, WGF's trader would then execute the transaction, whether it be a purchase or sale of securities. (Ex. Z, AA, AB, AC, AD and AE; RT 824-825, 827, 839).

The trading department had the responsibility of selecting a stockbroker. (RT 839, 180-181). This was done by the trader by shopping about to see which stockbroker could get the best price for the particular security. The trader would then place the buy or sell order with that stockbroker. (RT 833-834).

WGF had entered into a contract with City National Bank and Trust Company (hereinafter referred to as the "custodian bank") whereby the securities and cash of the fund were held by such bank as a custodian. (Ex. 5). The authorized officers of WGF, upon approval of the confirmation from the stockbroker, would then direct the custodian bank to pay over to the stockbroker money for the purchase of the securities or, if the transaction were a sale, have the custodian deliver the securities to the stockbroker upon payment of money by the stockbroker to the custodian. (RT 346-347, 852-854). It was undisputed at the time of trial that Sanders was an employee of Winfield & Co. The offices he occupied had the title thereon Winfield & Co., and he was paid a salary by Winfield & Co. in the course and scope of his employment.

(RT 132-134, Ex. B, Ex. N, p. 5; Ex. AK, p. 5 and Ex. A, p. 6).

During the period between December, 1969, through March of 1970, John P. Galanis in concert with others engaged in the artificial manipulation of the public market price of various securities for his own personal profit and gain and during that period made payments of money to Sanders in return for Sanders causing WGF and other mutual funds to purchase some of the securities being manipulated by Galanis. The payment of money was not specifically earmarked for the recommendation of any particular security nor with any particular direction as to which particular mutual fund the security should be recommended. The recommendation of the security by Sanders was made without regard to the investment merit of the stock and Sanders profited personally from these actions. (CT 354-357). WGF contends that as a result of the activities of Sanders as described above, it suffered losses and damages.

Winfield & Co., on behalf of various corporate entities known as the Winfield complex, purchased the bonds in question through its broker, Mark F. Hopkins & Co., Insurance Brokers, Inc., (Hopkins) from INA. (RT 1531, 1136, 1138). The joint insureds under the said bonds were Winfield & Co., Winfield Distributors, Winfield Growth Fund, Winfield Underwriters, Wincap Fund, Winfield Associates, AGE Fund, Applied Financial Systems. (Ex. 8, 9). WGF was subject to the Investment Company Act of 1940, and the rules and regulations thereunder. (CT 352). During the period from January 1, 1968, to December 14,

1970, Sec. 17(g) authorized the S.E.C. to adopt rules for the bonding of a registered management investment company and the S.E.C. did in fact adopt Rule 17g-1. The pertinent texts of Sec. 17(g) and Rule 17g-1 are set forth in full in the addenda.

Neither Winfield & Co. nor its employees were required to be bonded pursuant to any rule or regulation. (15 U.S.C. Sec. 80b-1, *et seq.*). Winfield & Co., being the investment adviser and the nexus corporation of the Winfield complex, purchased the bond for various reasons, including general business purposes, and also on behalf of WGF to satisfy its bonding requirements under Rule 17g-1. (RT 276-277, 1048, 1183).

Sec. 17(g) of the 1940 Act provided in pertinent part that the registered management investment company maintain a fidelity bond covering:

> "any officer or employee of a registered management investment company who may singly, or jointly with others, have access to securities or funds of any registered investment company, either directly or through authority to draw upon such funds or to direct generally the disposition of such securities . . . against larceny and embezzlement. . . ."

Mark Hopkins was an employee of Mark F. Hopkins & Co. Insurance Brokers, Inc. (RT 1136). It handled a general line of insurance, including fidelity insurance. (RT 1137). Hopkins, acting as a broker on behalf of Winfield & Co., dealt directly with the employees of Winfield & Co. with regard to the placement of the bonds in question in this instant action. (RT 1531, 1140, 1157, 1161, 1164-1165).

He first commenced discussions with Winfield & Co. in approximately 1959 to 1962 and thereafter, talked to a series of employees responsible for ordering fidelity insurance. (RT 1138, 1157, 1164). It was Hopkins' understanding that the trading loss exclusion applied to losses sustained by a named insured through dishonest trading on the part of its employees in customers' accounts. (RT 1144). He discussed such fact with Winfield & Co. (RT 1172-1173. The coverage was renewed in 1965, 1968 and 1969. (RT 224-225).

WGF had counsel in Philadelphia who were retained for advice in connection with S.E.C. matters as well as compliance with S.E.C. requirements. (R.T. 933-935, 937, 1077-1079). Such counsel were consulted periodically concerning bonding requirements and counsel in Philadelphia on occasion sent correspondence concerning bonding requirements to WGF. (Ex. M). The duty to determine the amount, type, form and coverage of fidelity insurance to be obtained by WGF pursuant to Rule 17g-1 rested with WGF's Board of Directors and the S.E.C. (Rule 17g-1(a)). The Board of Directors relied upon their counsel in Philadelphia to satisfy the bonding requirement of Rule 17g-1. (RT 356-357, 933-935, 1077-1079).

In addition thereto, WGF retained the services of an attorney as house counsel to advise them concerning S.E.C. matters. (RT 933-935). He read the fidelity bond in question herein, including the exclusions. He appeared before the Board and discussed the fidelity bonds in question. (RT 1659-1664).

Rule 17g-1 required WGF to file a copy of the fidelity bond obtained with the S.E.C. for S.E.C. approval. Although on one occasion the S.E.C. questioned the adequacy of the amount of the bond, it did not on any other occasion challenge the sufficiency of the type, terms or coverages obtained. (RT 331-333).

WGF knew and was aware that trading loss coverage was available under the bonds, but elected not to purchase trading loss coverage. (RT 1491-1492, 1497, 1504, 1506). Cost was one of the factors in that there was a substantial premium for the purchase of trading loss coverage. (RT 295-297, 720-721, 1490, 1506).

REASONS FOR DENYING THE WRIT

Neither An Investment Adviser Nor Its Employees Need Be Bonded

WGF's contention rests upon the fallacy that a portfolio manager is a person who exists separate and apart and is something different than an investment adviser. In other words, a special relationship exists between the Fund and the so-called "portfolio manager." The term "portfolio manager" is a general term used by WGF and is not a term used by either Congress or the S.E.C. in passing the legislation or promulgating the rules. A portfolio manager is nothing more than an employee of the investment adviser who makes recommendations to the investment adviser with regard to the portfolio of the Fund which is serviced by his employer (the investment adviser) (RT 1537-1540).

WGF then carries the fallacy one step further in arguing that a portfolio manager has the authority to direct generally the disposition of securities and as such falls within the purview of both the Act and the Rule as being a person who must be bonded. To fully understand the position and authority of Sanders, some reference must be made to the facts developed at trial. Winfield & Co., the investment adviser, is a distinct corporate entity from that of WGF, the investment company. A written contract was entered into between the investment company and the investment adviser to render services to the investment company, including portfolio advice. (Ex. 3). Sanders was employed by the investment adviser and was assigned the task of doing research and making recommendations with regard to the portfolio of WGF as well as the portfolio of other funds. (RT 826). Sanders would make his recommendations to his superior, an officer of the investment adviser. (RT 824). Upon approval by the officer of the investment advisor, the recommendation would then be forwarded to WGF for its approval or rejection. (RT 824, 828-829). Upon approval of the recommendation, WGF would then order a trader in the trading department to consummate the trade. (RT 839). Such trader was an employee of the Fund whose duty it was to actually hire a broker and consummate the execution of a purchase or sale of a security.

A portfolio manager is not defined in the Investment Company Act or the rules and regulations thereunder nor is it used in connection with the bonding requirements under Section 17 or Rule 17g-1.

It is well established that a rule of statutory construction should not be used to do violence to the plain and clear meaning of the statute or to violate Congressional intent.

As stated, *inter alia*, in 73 Am.Jr.2d, *Statutes*, Section 280, page 447:

> ". . . A liberal construction of a remedial statute does not authorize the court to place such judicial construction upon the language used as to effectuate its own conception of right rather than the legislative intent or to depart from the plain and obvious meaning of the language used or to give a forced unnatural construction thereto. . . ."

Since the generic term "portfolio manager" has little if no meaning, some analysis is required of the term "investment adviser."

Section 2 of the Act contains the general definitions, and Section 2(a)(20) defines an "investment adviser." An Investment Adviser is someone other than a bona fide officer, director, trustee, member of an advisory board or an employee of the investment company. If by "portfolio manager" WGF means investment adviser, Sanders could not be the investment adviser of WGF since pursuant to Section 2(a)(20) an employee of the fund is prohibited from being the investment adviser.

Furthermore, not only is a "portfolio manager" not defined in the Act or the rules, but a portfolio manager cannot have a special relationship with the fund for it is forbidden that anyone act as an investment adviser except as set forth in the Act. Section 15(a) of the Act in effect provides that it is unlawful for any person to serve as an Investment Adviser of a fund except pursuant to a written contract, which contract has to be approved by a majority of the outstanding voting securities of the fund, and the contract must precisely describe all the compensation

to be paid. Sanders could not be the investment adviser of the fund since there was no written contract between him and the fund to act in that capacity, and he was not paid.

Both Congress and the S.E.C. recognize that an employee of the investment adviser (Sanders) is not an employee of the fund. In 1966, the S.E.C. prepared a report to Congress entitled "Public Policy Implications of Investment Company Growth."[3] It was an in-depth study, including recommendations to Congress in connection with investment companies. In it, the S.E.C. recognized that persons occupying the position such as Sander's were not employees of the fund but employees of the investment adviser. Page 87 thereof states:

> "Like typical business enterprises elsewhere in the economy, some investment companies, especially closed end companies, are internally managed by officers and staffs employed directly by the companies. As noted in Chapter 2, however, the management function of most mutual funds is contracted out to an external investment advisory organization, the principals of which are the persons who organized and promoted the fund from its inception or the successors of such persons. In such instances, the analysts and other professional personnel on whose expertise the fund relies *are employees of the advisor, not of the fund.*"

In all candor, the directors of WGF recognized that Sanders was an employee of the investment adviser and not of the fund. (RT 1537-1540).

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[3]See, *Report of the Securities and Exchange Comm'n on the Public Policy Implications of Investment Company Growth*, H.R. Rep. 2337, 89th Cong., 2d Sess. (1966), (hereinafter "Public Policy Implications").

The "Public Policy Implications" Report by the S.E.C. was sent to Congress and, presumably Congress read the same. It appears that no change in the Section or the Act was forthcoming in connection with the S.E.C.'s opinion that persons such as Sanders are not considered by the S.E.C. to be employees of the fund and, presumably, therefore, need not be bonded pursuant to Rule 17g-1.

Congress at the time of enacting the Investment Company Act of 1940 simultaneously enacted the Investment Advisers Act. No requirements were set forth therein requiring an investment adviser to be bonded. No mention is made of a "portfolio manager" required to be bonded.

If Sanders was a covered person under Section 17(g) as contended by WGF there would be no necessity for the S.E.C. and Congress to contemplate proposed legislation amending the Investment Advisers Act of 1940 to provide substantial additional protection to investment advisory clients. In Investment Advisers Act Release No. 491, December 15, 1975 (CCH Mutual Funds Guide, ¶ 80,381, 85,893) the S.E.C. proposed legislation to amend the Investment Advisers Act of 1940.

WGF's petition suggests, at page 20, that the court below was confused as to the year that Congress considered amending the Investment Advisers Act to authorize the SEC to require bonding of investment advisers. By the SEC's Investment Advisers Act Release No. 491, dated December 15, 1975, the industry was advised of the proposed amendments in full text. It was to this 1975 SEC release that the court below referred. Hearings were held

in 1976 by the Senate Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs.

New subsection (f) of Section 208 of that Act would have authorized the S.E.C. to provide through rules and regulations such safeguards as are necessary in the public interest or for the protection of investors with respect to the financial responsibility of the investment advisers. In an accompanying letter to Congress, the S.E.C. noted the inadequacy of the investment advisers regulation and proposed amendments to provide substantial additional protection to investment advisory clients. The letter, in part, provided:

> "At the present time there are no specific requirements imposed by the act on investment advisors in order to assure that they have the financial strength necessary to carry out their functions in a manner consistent with their obligations to clients, *nor are they subject to bonding requirements to prevent losses to clients which might result from embezzlement, misappropriation, breach of duty or insolvency.*" CCH, Mutual Funds Guide, ¶80,381, 85,901 (1975). [Emphasis added]

That the SEC proposed a new requirement that advisers be bonded is indicative of the legislative gap that existed at that time in that the scope of Section 17(g) and Rule 17g-1 has always been limited to those having actual access to the fund's assets, either directly or by authority to give instructions to the custodian bank. If the dishonest conduct of persons such as Sanders was intended to be included within the bonding requirements of Rule 17g-1, why would the SEC have recommended to Congress and Congress

have entertained a bill requiring bonding of an investment adviser at that time.

To ascertain who must be bonded under Section 17(g) an analysis of the Act as well as the intent of Congress and S.E.C.'s interpretation of Congressional intent is required. INA contends the proper construction to be rendered to Sec. 17(g) is as follows. Only officers and employees of the fund are required to be bonded, provided such person has access to the securities or funds (money) of the investment company, either directly, where there is no custodian so that the investment company has possession of both its securities and its funds, or where the investment company does not have possession of its securities and funds (money) because there is a custodian. (See Sec. 17(f) and Rule 17f-(a) through (d).) Bonding is still required of those officers and employees who have the authority to order or direct the custodian to release the securities or the funds. It is INA's contention that only those covered persons heretofore described must be bonded against larceny and embezzlement. The words "to direct generally the disposition of such securities" does not mean to include an employee of the investment advisor giving improper advice but is intended to include and be limited only to those officers and employees of the fund who have been authorized by a resolution of the Board of Directors to be empowered to order the custodian to release possession of the securities or the funds. INA contends that the foregoing interpretation of both the Act and the Rule is the only proper interpretation.

Prior to 1940, mutual funds represented a small section of investment business and were relatively unregulated. As WGF has pointed out, there were hearings preceding the enactment of the Investment Company Act of 1940.[4]

As a result of the 1940 hearings, Congress was aware of the problems created by the very liquid nature of the assets involved (Senate Hearings, pages 72, 125) as well as the customary relationship between an investment trust and its adviser. (Senate Hearings, pages 251-254.)

The conclusion of the court below is supported when Section 17 of the Act is read as a whole and is further supported in that the S.E.C. represented to Congress that there need not be any bonding requirements at the time the Investment Company Act was passed in 1940, because the securities were adequately protected from physical taking by the placing of the portfolio securities in a custodian account.

Although Congress authorized the S.E.C. to pass rules requiring bonding, there was no such bonding requirement until 1947. Between 1940 and 1947, the S.E.C. was satisfied that there was adequate protection by virtue of the custodial arrangements of the securities of the mutual fund. The "Senate Hearings", page 264 *et seq.*, gives a discussion of the bonding section by Mr. David Schenker, the then Chief Counsel to the S.E.C. in charge of the Investment Trust Study:

> "Mr. Schenker: We still have not recommended that it is necessary at this time to go so far [as to require bonding of officers and employees.]

[4]*Hearings on S. 3580 Before a Subcommittee of the Senate Committee on Banking and Currency*, 76th Cong. 3d Sess. (1940), (hereinafter "Senate Hearings").

Paragraph (2) of subsection (g) of Section 17 says that in the future if the situation is such that the protection of investors requires it the Commission may make rules and regulations with respect to bonding employees."

The "Senate Hearings" go on to say, at page 280, that the custodian arrangements were considered to grant sufficient safeguards at that time.

If dishonestly induced portfolio transactions by an investment adviser's employee had been intended by Congress to be included within the bonding provisions of Section 17(g), Congress would have acted to require bonding because that exposure existed prior to 1940, as well as since. If Congress had intended the words "to direct generally the disposition of such securities" to include employees of the investment advisor, a point which we do not concede, Congress would not have used the word "may" with reference to "access." Congress would have required bonding at all times and in all instances because the employee of an investment advisor would always be making investment recommendations whereas the officer or employee of the investment company may or may not have access to the securities, depending upon custodian relationships and the authority from the board of directors authorizing that particular officer or employee to be the designated person to have access.[5]

[5]Such Congressional intent is supported by the comment contained in "Public Policy Implications," page 65, footnote 206, which states:

"In its report on the bill which later became the act, the Senate Committee on Banking and Currency stated: 'Basically the problems fall from the very nature of the assets of investment companies. The assets of such companies invariably consist of cash and securities, assets which are completely liquid, mobile and readily negotiable. Because of these characteristics, control of such funds offers manifold opportunities for exploitation by the the unscrupulous management of some companies. These assets can and have been easily misappropriated and diverted by such types of managements and have been employed to foster their personal interests rather than the interests of public security holders.' "

Congressional intent can be ascertained by further examination of Section 17(f) which prescribes severe limitations on the possession of the securities, to prohibit the taking of such securities. If the heart of the Congressional scheme was to remedy the type of abuse committed by Sanders, to wit, dishonest portfolio recommendations Congressional enactment of custodian possession of securities would hardly prevent the sort of conduct committed by Sanders since custodian possession of securities would have no effect upon dishonest advice by the alleged "Portfolio Manager."

It should be pointed out that until 1971, there was no requirement that the cash of a mutual fund had to be kept in the possession of a custodian. This large pool of money was subject to being stolen or embezzled by officers and employees of the fund. Section 17(f) required custodial arrangements only for "securities and similar investments." It was not until 1971 that Section 17(f) was amended by Congress to require that if an investment company maintained its securities in the custody of such a bank, it must also maintain its cash assets in the custody of such bank. Thus from the time Section 17(f) was enacted, until 1971, an investment company could main-

tain its cash assets outside a custodial arrangement. Section 17(g) bonding requirements protected these cash assets.

The reading of Sections 17(f), (g), (j) and 37 shows consistently what Congress intended. Section 17(f) allows a fund to have possession of its securities. Section 17(g) requires bonding against larceny and embezzlement of the fund's officers and employees who have "access" to those securities. No mention is made therein of other persons or persons who may give dishonest portfolio advice. Congress could have and would have mentioned in Section 17(g), bonding requirements to protect against improper investment advice since Congress was aware at that time of investment advisers and their employees, in that it enacted the Investment Advisers Act simultaneously therewith. Congress thereafter also enacted Section 17(j) which demonstrates Congress' intent and knowledge of improprieties available to persons capable of rendering improper portfolio advice. Section 17(j) is a prohibition against self-dealing and is not limited to employees of the fund but includes affiliated persons of the investment adviser such as Sanders. Yet when passing Section 17(j), Congress, by its silence, demonstrated its intent that the bonding requirements under Section 17(g) referred only to officers and employees of the fund and not to employees of an investment adviser.[6]

[6]There was no evidence that Sanders was an authorized person pursuant to a resolution of the Board of Directors of WCF as one of the persons who could order the custodian bank to release its securities. He was, therefore, not a person who was authorized "to direct generally the disposition of securities." Lovejoy testified that the employees of Winfield & Co. had no access to the cash or securities and that the only person who had *access* with respect to the disposition of those assets would be the Fund's officers. (RT 346-347. See also RT 852-853, Ex. 5, p. 6).

The S.E.C. amended Rule 17g-1 both in 1964 and 1974. On neither occasion did the S.E.C. see fit to require bonding beyond larceny and embezzlement, nor did it see fit to require bonding of so-called "portfolio managers." The S.E.C. recognizes that it has no authority to require the bonding of an investment advisor pursuant to Section 17(g) and, therefore, in December of 1975 requested that Congress amend the Investment Advisers Act so that the S.E.C. could require bonding of investment advisors.

The S.E.C. recognized that Congress did not intend that the investment adviser be bonded under Section 17(g) in that the S.E.C. in 1974 amended Rule 17g-1 and specifically permitted the investment adviser to be named as a joint insured along with the investment company. However, such joinder was made permissive and not mandatory. "The use of joint insured bonds by investment companies is permissive rather than mandatory." (Ex. AS, p. 1; C.L. 17).

In the 1976 Senate hearings regarding the S.E.C.'s proposed amendments to the Investment Advisers Act, the S.E.C. repeatedly stressed that there were no federal bonding requirements for investment advisers or their employees, regardless of whatever services they performed. (1976 Senate Hearings, pages 6, 7, 13, 14, 15.)

From the foregoing, it readily appears that there is no statutory requirement under the Investment Company Act of 1940, as amended, that an employee of an investment adviser be bonded. There is no statutory requirement under the Investment Advisers Act of 1940, as amended, that the employees of an investment adviser be bonded. Therefore, both the trial court and the Ninth Circuit Court

of Appeals were correct when they applied the express provisions of the "trading loss" exclusion in INA's bonds to the facts of this case. WGF received the exact coverage which it elected to purchase from INA and for which it paid a substantially lower premium than it would have paid had WGF elected to purchase trading loss coverage.

CONCLUSION

The writ must be denied.

Respectfully submitted,
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ADDENDUM

Addendum "A"

INVESTMENT COMPANY ACT OF 1940

General Definitions

SEC. 2 (a) When used in this title, unless the context otherwise requires—

* * *

(20) "Investment adviser" of an investment company means (A) any person (other than a bona fide officer, director, trustee, member of an advisory board, or employee of such company, as such) who pursuant to contract with such company regularly furnishes advice to such company with respect to the desirability of investing in, purchasing or selling securities or other property, or is empowered to determine what securities or other property shall be purchased or sold by such company, and (B) any other person who pursuant to contract with a person described in clause (A) regularly performs substantially all of the duties undertaken by such person described in clause (A); but does not include (i) a person whose advice is furnished solely through uniform publications distributed to subscribers thereto, (ii) a person who furnishes only statistical and other factual information, advice regarding economic factors and trends, or advice as to occasional transactions in specific securities, but without generally furnishing advice or making recommendations regarding the purchase or sale of securities, (iii) a company furnishing such services at cost to one or more investment companies, insurance companies, or other financial institutions, (iv) any person the character and amount of whose compensation for such services must be approved by a court, or (v) such other persons as the Commission may by rules and regulations or order determine not to be within the intent of this definition.

Addendum "B"

INVESTMENT COMPANY ACT OF 1940

Investment Advisory and Underwriting Contracts

SEC. 15. (a) After one year from the effective date of this title it shall be unlawful for any person to serve or act as investment advisor of a registered investment company, except pursuant to a written contract, which contract, whether with such registered company or with an investment adviser of such registered company, unless in effect prior to March 15, 1940, has been approved by the vote of a majority of the outstanding voting securities of such registered company and—

(1) precisely describes all compensation to be paid thereunder;

(2) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company;

(3) provides, in substance, that it may be terminated at any time, without the payment of any penalty, by the board of directors of such registered company or by vote of a majority of the outstanding voting securities of such company on not more than sixty days' written notice to the investment adviser; and

(4) provides, in substance, for its automatic termination in the event of its assignment by the investment adviser.

(b) After one year from the effective date of this title, it shall be unlawful for any principal underwriter for a registered open-end company to offer for sale, sell or deliver after sale any security of which said company is the issuer, except pursuant to a written contract with such company, which contract, unless, in effect prior to March 15, 1940—

(1) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company; and

(2) provides, in substance, for its automatic termination in the event of its assignment by such underwriter.

(c) In addition to the requirements of subsections (a) and (b) it shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, except a written agreement which was in effect prior to March 15, 1940, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved (1) by a majority of the directors who are not parties to such contract or agreement or affiliated persons of any such party, or (2) by the vote of a majority of the outstanding voting securities of such company.

(d) It shall be unlawful for any person—

(1) to serve or act as investment adviser of a registered investment company, pursuant to a written contract which was in effect prior to March 15, 1940, after March 15, 1945, or the date of termination provided for in such contract, whichever is the prior date, or after assignment thereof subsequent to March 15, 1940, by the person acting as investment adviser thereunder; or

(2) as principal underwriter for a registered open-end investment company to offer for sale, sell, or deliver after sale any security of which such company is the issuer, pursuant to a written contract which was in effect prior to March 15, 1940, after March 15, 1945, or the date of termination provided for in such contract, whichever is the prior date, or after assignment thereof subsequent to March 15, 1940, by the person acting as principal underwriter thereunder:

Provided, however, That the limitation to March 15, 1945, shall not apply in either case if prior to that date such contract is renewed in such form that it complies with the requirements of subsection (a) or (b) of this section, as the case may be, and is approved in the manner required by this section in respect of a contract of the same character made after March 15, 1940.

(e) In the case of a common-law trust of the character described in subsection (b) of section 16, either written approval by holders of a majority of the outstanding shares of beneficial interest or the vote of a majority of such outstanding shares cast in person or by proxy at a

meeting called for the purpose shall for the purposes of this section be deemed the equivalent of the vote of a majority of the outstanding voting securities, and the provisions of paragraph (40) of section 2 (a) as to a majority shall be applicable to the vote cast at such a meeting.

(f) Nothing contained in this section shall be deemed to require or contemplate any action by an advisory board of any registered company or by any of the members of such a board.

Addendum "C"

INVESTMENT COMPANY ACT OF 1940

Sec. 17

* * *

(f) Every registered management company shall place and maintain its securities and similar investments in the custody of (1) a bank having the qualifications prescribed in paragraph (1) of section 26 (a) for the trustees of unit investment trusts; or (2) a company which is a member of a national securities exchange as defined in the Securities Exchange Act of 1934, subject to such rules and regulations as the Commission may from time to time prescribe for the protection of investers; or (3) such registered company, but only in accordance with such rules and regulations or orders as the Commission may from time to time prescribe for the protection of investers. Rules, regulations, and orders of the Commission under this subsection, among other things, may make appropriate provision with respect to such matters as the earmarking, segregation, and hypothecation of such securities and investments, and may provide for or require periodic or other inspections by any or all of the following: Independent public accountants, employees and agents of the Commission, and such other persons as the Commission may designate. No such member which trades in securities for its own account may act as custodian except in accordance with rules and regulations prescribed by the Commission for the protection of investers.

(g) The Commission is authorized to require by rules and regulations or orders for the protection of investers that any officer or employee of a registered management

investment company who may singly, or jointly with others, have access to securities or funds of any registered company, either directly or through authority to draw upon such funds or to direct generally the disposition of such securities (unless the officer or employee has such access solely through his position as an officer or employee of a bank) be bonded by a reputable fidelity insurance company against larceny and embezzlement in such reasonable minimum amounts as the Commission may prescribe.

* * *

(j) It shall be unlawful for any affiliated person of or principal underwriter for a registered investment company or any affiliated person of an investment adviser of or principal underwriter for a registered investment company, to engage in any act, practice, or course of business in connection with the purchase or sale, directly or indirectly, by such person of any security held or to be acquired by such registered investment company in contravention of such rules and regulations as the Commission may adopt to define, and prescribe means reasonably necessary to prevent, such acts, practices, or courses of business as are fraudulent, deceptive or manipulative. Such rules and regulations may include requirements for the adoption of codes of ethics by registered investment companies and investment advisers of, and principal underwriters for, such investment companies establishing such standards as are reasonably necessary to prevent such acts, practices, or courses of business.[1]

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[1]Subsection (j) added, eff. December 14, 1970, Public Law 91-547, sec. 9(c), 84 Stat. 1421.

Addendum "D"

INVESTMENT COMPANY ACT OF 1940

Larceny and Embezzlement

SEC. 37. Whoever steals, unlawfully abstracts, unlawfully and willfully converts to his own use or to the use of another, or embezzles any of the moneys, funds, securities, credits, property, or assets of any registered investment company shall be deemed guilty of a crime, and upon conviction thereof shall be subject to the penalties provided in section 49. A judgment of conviction or acquittal on the merits under the laws of any State shall be a bar to any prosecution under this section for the same act or acts.

Addendum "E"

Rule 17f-1. Custody of Securities With Members of National Securities Exchanges

(a) No registered management investment company shall place or maintain any of its securities or similar investments in the custody of a company which is a member of a national securities exchange as defined in the Securities Exchange Act of 1934 (whether or not such company trades in securities for its own account) except pursuant to a written contract which shall have been approved, or if executed before January 1, 1941, shall have been ratified not later than that date, by a majority of the board of directors of such investment company.

(b) The contract shall require, and the securities and investments shall be maintained in accordance with the following:

(1) The securities and similar investments held in such custody shall at all times be individually segregated from the securities and investments of any other person and marked in such manner as to clearly identify them as the property of such registered management company, both upon physical inspection thereof and upon examination of the books of the custodian. The physical segregation and marking of such securities and investments may be accomplished by putting them in separate containers bearing the name of such registered management investment company or by attaching tags or labels to such securities and investments.

(2) The custodian shall have no power or authority to assign, hypothecate, pledge or otherwise to dispose of any such securities and investments, except pursuant to the direction of such registered management company and only for the account of such registered investment company.

(3) Such securities and investments shall be subject to no lien or charge of any kind in favor of the custodian or any persons claiming through the custodian.

(4) Such securities and investments shall be verified by actual examinations at the end of each annual and semi-annual fiscal period by an independent public accountant retained by the registered management investment company, and shall be examined by such accountant at least one other time, chosen by him, during the fiscal year. Certificates of such independent public accountant stating that he has made an examination of such securities and investments, and describing the nature of the examination, shall be transmitted to the Commission promptly after each such examination.

(5) Such securities and investments shall, at all times, be subject to inspection by the Commission through its employees or agents.

(6) The provisions of (1), (2) and (3) shall not apply to securities and similar investments bought for or sold to such investment company by the company which is custodian until the securities have been reduced to the physical possession of the custodian

and have been paid for by such investment company: *Provided,* That the company which is custodian shall take possession of such securities at the earliest practicable time. Nothing in this subparagraph shall be construed to relieve any company which is a member of a national securities exchange of any obligation under existing law or under the rules of any national securities exchange.

(c) A copy of any contract executed or ratified pursuant to paragraph *(a)* shall be transmitted to the Commission promptly after execution or ratification unless it has been previously transmitted.

(d) Any contract executed or ratified pursuant to paragraph *(a)* shall be ratified by the board of directors of the registered management investment company at least annually thereafter.

Addendum "F"

Rule 17f-2. Custody of Investments by Registered Management Investment Company

(*a*) The securities and similar investments of a registered management investment company may be maintained in the custody of such company only in accordance with the provisions of this rule. Investments maintained by such a company with a bank or other company whose functions and physical facilities are supervised by Federal or State authority under any arrangement whereunder the directors, officers, employees or agents of such company are authorized or permitted to withdraw such investments upon their mere receipt, are deemed to be in the custody of such company and may be so maintained only upon compliance with the provisions of this rule.

(*b*) Except as provided in paragraph (*c*), all such securities and similar investments shall be deposited in the safekeeping of, or in a vault or other depository maintained by, a bank or other company whose functions and physical facilities are supervised by Federal or State authority. Investments so deposited shall be physically segregated at all times from those of any other person and shall be withdrawn only in connection with transactions of the character described in paragraph (*c*).

(*c*) The first sentence of paragraph (*b*) shall not apply to securities on loan which are collateralized to the extent of their full market value, or to securities hypothecated, pledged, or placed in escrow for the account of such investment company in connection with a loan or other transaction authorized by specific resolution of its board

of directors, or to securities in transit in connection with the sale, exchange, redemption, maturity or conversion, the exercise of warrants or rights, assents to changes in terms of the securities, or other transactions necessary or appropriate in the ordinary course of business relating to the management of securities.

(d) Except as otherwise provided by law, no person shall be authorized or permitted to have access to the securities and similar investments deposited in accordance with paragraph *(b)* except pursuant to a resolution of the board of directors of such investment company. Each such resolution shall designate not more than five persons who shall be either officers or responsible employees of such company, and shall provide that access to such investments shall be had only by two or more such persons jointly, at least one of whom shall be an officer; except that access to such investments shall be permitted (1) to properly authorized officers and employees of the bank or other company in whose safekeeping the investments are placed and (2) for the purpose of paragraph *(f)* to the independent public accountant jointly with any two persons so designated or with such officer or employee of such bank or such other company. Such investments shall at all times be subject to inspection by the Commission through its authorized employees or agents accompanied, unless otherwise directed by order of the Commission, by one or more of the persons designated pursuant to this paragraph.

(e) Each person when depositing such securities or similar investments in or withdrawing them from the depository or when ordering their withdrawal and delivery from the safekeeping of the bank or other company, shall sign a notation in respect of such deposit, withdrawal or order which shall show (1) the date and time of the deposit, withdrawal or order, (2) the title and amount of the securities or other investments deposited, withdrawn or ordered to be withdrawn, and an identification thereof by certificate numbers or otherwise, (3) the manner of acquisition of the securities or similar investments deposited or the purpose for which they have been withdrawn, or ordered to be withdrawn, and (4) if withdrawn and delivered to another person the name of such person. Such notation shall be transmitted promptly to an officer or director of the investment company designated by its board of directors who shall not be a person designated for the purpose of paragraph *(d)*. Such notation shall be on serially numbered forms and shall be preserved for at least 1 year.

(f) Such securities and similar investments shall be verified by complete examination by an independent public accountant retained by the investment company at least three times during each fiscal year, at least two of which shall be chosen by such accountant without prior notice to such company. A certificate of such accountant, stating that he has made an examination of such securities and investments and describing the nature and extent of the examination shall be transmitted to the Commission by the accountant promptly after each examination.

Addendum "G"

Rule 17g-1. Bonding of Officers and Employees of Registered Management Investment Companies

(a) Each registered management investment company shall provide and maintain a bond which shall be issued by a reputable fidelity insurance company, authorized to do business in the place where the bond is issued, against larceny and embezzlement, covering each officer and employee of the investment company, who may singly, or jointly with others, have access to securities or funds of the investment company, either directly or through authority to draw upon such funds or to direct generally the disposition of such securities (hereinafter referred to as "covered persons"). The bond may be in the form of an individual bond for each covered person or a schedule or blanket bond covering all covered persons; shall provide that it shall not be cancelled, terminated or modified except after written notice shall have been given by the acting party to the affected party and to the Commission not less than 30 days prior to the effective date of cancellation, termination or modification; and shall be in such reasonable amount as a majority of the board of directors of the investment company who are not covered persons shall determine, with due consideration to the value of the aggregate assets of the investment company to which any covered person may have access, the type and terms of the arrangements made for the custody and safekeeping of such assets, and the nature of securities in the company's portfolio. This determination shall be made at least once each year. Notwithstanding any such determination the Commission may in any case, by order

after appropriate notice and opportunity for hearing, prescribe reasonable minimum amounts of coverage, with reference to the type and form of the bond or bonds for each covered person or each class of covered persons.

(b) Each registered management investment company shall—

(1) File with the Commission within 10 days after the execution of the bond or any amendment thereof (i) a copy of each resolution of the board of directors of the investment company determining the amount, type, form and coverage of each such bond, (ii) a statement as to the period for which the premiums for each bond have been paid, and (iii) a copy of each such bond and each amendment thereto, and

(2) File with the Commission, in writing, within 5 days after the making of a claim under the bond by the investment company, a statement of the nature and amount thereof, and

(3) File with the Commission, within 5 days of the receipt thereof, a copy of the terms of the settlement of any claim made under the bond by the investment company, and

(4) Notify by registered mail each member of the board of directors of the investment company at his last known residence address of (i) any cancellation, termination or modification of the bond, not less than 20 days prior to the effective date of cancellation, termination, or modification and (ii) the filing and of

the settlement of any claim under the bond by the investment company, at the time the filings required by subparagraphs (2) and (3) of this paragraph are made with the Commission.

(c) Each registered management investment company shall designate an officer thereof who shall make the filings and give the notices required by paragraph *(b)* of this rule.

(d) The information set forth in the filings required by subparagraphs (2) and (3) of paragraphs (*b*) of this rule shall not be made available to the public unless and except insofar as the Commission finds that public disclosure of the whole or any part thereof is necessary or appropriate in the public interest or for the protection of investors.

(e) Where the registered management investment company is an unincorporated company managed by a depositor or investment adviser, the terms "officer" and "employee" shall include, for the purposes of this rule, the officers and employees of the depositor or investment adviser.

(f) Not later than 1 year from August 1, 1964, arrangements between registered management investment companies and fidelity insurance companies which would not permit compliance with the provisions of this rule shall be modified by the parties so as to permit such compliance.

IN THE
Supreme Court of the United States
OCTOBER TERM, 1979

No. 79-584

RESEARCH EQUITY FUND, INC.,
Petitioner
v.
THE INSURANCE COMPANY OF NORTH AMERICA,
Respondent

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

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PETITIONER'S REPLY MEMORANDUM

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PETITIONER'S REPLY MEMORANDUM

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1. After the filing of our Petition, this Court decided *Transamerica Mortgage Advisors, Inc.* v. *Lewis,* No. 77-1645 (Nov. 13, 1979). The Court's opinion observes, with respect to a 1976 bill to revise the Investment Advisers Act, that "[t]he Senate Committee reported favorably on the provision as proposed by the Commission, but the bill did not come to a vote in either House." [1]

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[1] ***Transamerica Mortgage Advisors, Inc.*** **v.** ***Lewis, supra,*** **48 U.S. Law Week at 4004 n. 13; *compare* Petition, at p. 20 ("the bill was reported favorably by the Senate Banking Committee, but never reached a floor note in either House").**

The court of appeals in this case, however, erroneously referred to the same bill as having been "rejected" by Congress and, what is more, relied on this supposed rejection for its interpretation of Section 17(g) of the Investment Company Act of 1940.[2] Indeed, on the face of its opinion, this mistaken reasoning of the court of appeals constitutes the primary basis for its construction of Section 17(g), as we pointed out in our Petition (Pet., at pp. 20-21).

2. As to the legislative history of Section 17(g) itself, both the court of appeals and now respondent in this Court are silent. Respondent has neither discussed the legislative materials set forth in our Petition (at pp. 16-19), nor offered any reason why Congress would have excluded from bonding coverage portfolio managers like Sanders, who are supplied to mutual funds by investment advisers, when the original draft of Section 17(g) plainly included such persons and no substantial change was intended in the enacted version (see Pet., at pp. 16-18).[3]

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[2] The court of appeals said: "In rejecting such legislation, Congress obviously contemplated that the bonding requirement would be applicable only to those persons who are in fact officers or employers of the mutual fund" (Pet. App. 9a).

Our Petition also notes, as did this Court in *Transamerica, supra,* 48 U.S. Law Week at 4004 n. 13, that what Congress did in 1976 regarding another Act can have little or no bearing on what the 1940 Congress intended regarding Section 17(g) (Pet., at p. 20).

[3] In suggesting that the term "'portfolio manager' has little if no meaning" (Brief in Opp., at p. 10), respondent ignores that Section 17(g) of the original bill used the term "manager" of or for a mutual fund to designate those persons who were subject to bonding coverage and that the bill as enacted, although not using the term, was intended to have the same meaning as the original version (see Pet., at pp. 16 to 18).

While ignoring the history of Section 17(g) of the Investment Company Act, respondent asserts that mutual fund managers like Sanders need not be bonded because there is no bonding requirement for investment advisers[4]—an argument we find difficult to understand in light of respondent's recognition that "Sanders could not be the investment advisor of the fund."[5] But aside from the apparent inconsistency in respondent's position, it is unresponsive to the important issue in this use. What matters is whether a mutual fund's management personnel, supplied by an investment adviser and operating as the functional equivalent of fund employees (Pet. App. 8b), were intended to be treated as fund employees for the purposes of Section 17(g). On that score, the legislative history of Section 17(g) demonstrates beyond doubt that they were.

3. Respondent does not dispute that the issue presented in this case is a highly significant one to the mutual fund industry, to insurers and to investors.

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[4] Brief in Opp., at p. 12.

[5] *Id.* at p. 11. Respondent's various references to S.E.C. statements that investment advisers need not be bonded are not only beside the point but also are taken out of context. The Investment Advisers Act, to be sure, contains no bonding requirement. But it is through the Investment Company Act that Congress regulated the relationship between mutual funds and management personnel supplied by their investment advisers. The S.E.C. statements respondent relies upon were not addressed to that situation. As the Commission stated to the court of appeals, it "was referring only to the absence in the Investment Advisers Act of any bonding requirement for advisers generally. The Commission was not suggesting that the Investment Company Act contained no bonding requirement applicable in the case of an adviser to an investment company." (*Memorandum of the Securities and Exchange Commission, Amicus Curial, In Support of Rehearing,* at p. 4 n.5).

The decision below will govern the degree to which investors are protected against dishonesty by mutual fund managers because, as we pointed out in our Petition (at pp. 10-13), the management personnel of most mutual funds are furnished by investment advisers. Review by this Court is thus necessary to avoid subjecting the investing public to substantial risks of loss on the basis of a plain misconstruction of the Investment Company Act, which if left standing can only bring about years of further confusion and litigation.

Respectfully submitted,

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December 1979

No. 79-584

IN THE
Supreme Court of the United States
OCTOBER TERM, 1979

RESEARCH EQUITY FUND, INC.,
Petitioner
v.

THE INSURANCE COMPANY OF NORTH AMERICA,
Respondent

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

SUPPLEMENTAL BRIEF FOR PETITIONER

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PRESS OF BYRON S. ADAMS PRINTING, INC., WASHINGTON, D. C.

IN THE

Supreme Court of the United States

October Term, 1979

No. 79-584

Research Equity Fund, Inc.,
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Respondent

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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SUPPLEMENTAL BRIEF FOR PETITIONER

Pursuant to Rule 24(5) of the Rules of this Court, this supplemental brief addresses the brief *amicus curiae* of the United States, filed on February 29, 1980, in response to the Court's order of January 7, 1980, inviting the Solicitor General to file a brief expressing the views of the United States in this case.

1. While agreeing that the decision of the court of appeals is in error and that the case is important, the government in its *amicus* brief suggests that review

may not be "essential" because the Securities and Exchange Commission is considering whether to promulgate new regulations interpreting Section 17(g) of the Act and, in effect, overruling the decision in this case.

The government's position assumes that the decision interprets the existing Commission regulations under Section 17(g), rather than the statute itself. That is a view we do not share. The opinion of the court of appeals rests quite clearly on statutory interpretation: it discusses what Congress intended in Section 17(g) and it holds that Congress did not intend to have bonding coverage extended to mutual fund portfolio managers supplied by investment advisers because they are not Section 17(g) "employees."[1] At one point at least, the Commission itself thus viewed the opinion. In its *amicus* submission on petition for rehearing, it told the court of appeals that the court's result was "anomalous" and one that "*Congress* could hardly have intended"—a statement the government quotes in its *amicus* brief in this Court.[2]

While the government suggests that the Commission has rulemaking authority under Section 38 of the Act (15 U.S.C. 80a-37(a)) to define the term "employee," any court considering such regulation would refer back to Section 17(g) to determine the scope of

[1] See, *e.g.*, Pet. App. 10a ("*Congress* obviously contemplated the bonding requirement would be applicable only to those persons who are in part officers or employees of the mutual fund"); *id.* at 10a ("Since the *statute* does not require coverage for the losses suffered by WGF at the hands of someone such as Sanders . . . .").

[2] Brief for the United States as *Amicus Curiae,* at p. 4.

the Commission's powers, as the court did in *SEC* v. *Talley Industries, Inc.,* 399 F.2d 396, 404 (2d Cir. 1968), *cert. denied,* 393 U.S. 1015. If the opinion of the court below prevails, the regulations would be struck down. The Commission's rulemaking authority may be considerable, as the government says, but it cannot overrule a federal appellate court's interpretation of a statute.[3] That is the function of this Court when an important case has been wrongly decided.[4]

2. Furthermore, even if the Commission does engage in rulemaking (and there is no assurance by the government whether or when it will) and even if other courts eventually uphold the new rules,[5] this would hardly cure the problem created by the court of appeals decision in this case. Regulations are not retroactive. Unless that decision is reversed, investors in mutual funds that have bonds like petitioner's will have been stripped of bonding protection for losses suffered in the past through the dishonesty of portfolio managers. (Fidelity bonds are "discovery" bonds,

[3] See, *e.g.*, *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 213 (1976) ("The rulemaking power granted to a federal agency charged with the administration of a federal statute is not the power to make law.").

[4] If this Court upheld petitioner's and the Commission's interpretation of Section 17(g), the Commission would of course be free to implement that interpretation through further regulations if it thought these necessary or desirable.

[5] We have noted before that "This is peculiarly an area in which a definite and uniform rule should prevail. Only then can the cost of protecting investors against dishonesty by fund managers be spread equitably throughout the mutual fund industry and only then can insurers and mutual funds be certain of the coverage that, at a minimum, must be maintained for the protection of investors." Pet. 13-14.

which provide protection from the point the fraud is discovered.) This is why the Investment Company Institute, as *amicus curiae,* has informed the Court that the decision here adversely affects the 7 million shareholders of the mutual funds it represents.[6]

CONCLUSION

Review by this Court is essential and the petition for a writ of certiorari should be granted.

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[6] Brief of the Investment Company Institute, *Amicus Curiae,* at pp. 2, 5.

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Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

RESPONDENT'S REPLY TO SUPPLEMENTAL BRIEF FOR PETITIONER

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RESPONDENT'S REPLY TO SUPPLEMENTAL BRIEF FOR PETITIONER

Pursuant to Rule 24(5) of the Rules of this Court, this responsive brief addresses the supplemental brief for petitioner filed in the within matter. Said supplemental brief for petitioner addressed the brief *amicus curiae* of the United States, filed on February 29, 1980, in response to the Court's Order of January 7, 1980, inviting the Solicitor General to file a brief expressing the views of the United States in this case.

The government's brief, while critical of the opinion of the court below, concluded that the SEC believed that review by this Court at this time was not essential in light of the SEC's rule-making authority.

Petitioner makes two points in its supplemental brief. Petitioner first argues that the government's position assumes that the decision interprets the existing Commission regulations under Section 17g rather than the statute itself. The second point addressed in petitioner's supplemental brief is that any rule making done by the SEC in this matter would hardly cure the problem because such regulations are not retroactive.

I.

SECTION 17g OF THE INVESTMENT COMPANY ACT OF 1940 REQUIRES NO BOND BUT MERELY PERMITS THE SEC TO REQUIRE BONDING BY RULES AND REGULATIONS.

Petitioner's supplemental brief argues that the opinion of the Court of Appeals rests quite clearly on statutory interpretation as opposed to the interpretation of the rules and regulations promulgated pursuant to the enabling legislation.

Section 17g of the Investment Company Act of 1940 merely permits the Commission to enact rules and regulations requiring bonding of any officer or employee of a registered management investment company who may singly, or jointly with others, have access to securities or funds of any registered company.

The opinion of the Court below is set forth as Appendix A to the petition in the within matter.

Reference to said opinion clearly demonstrates that the Court below considered both the statute and the regulation. (Petition, p. 7a.) The Court below noted that interpretation of a bond to provide coverage beyond its literal terms is permissible only to the extent that such coverage is required by the statute. Rule

17g-1 requires that management investment companies obtain coverage against larceny or embezzlement committed by its officers and employees.

The trial court concluded that the provisions of the trading loss exclusion were unambiguous. Research Equity now asks this Court to rewrite the bonds even though they were purchased by Winfield with the full knowledge that it was not purchasing trading loss coverage and that it was saving a premium by doing so. California has long recognized that an insured must pay a premium for the coverage afforded, and the payment of a premium when due is the essence of an insurance contract. *Methvin* v. *Fidelity Mutual Life Association* (1900) 129 Cal. 251; *Burton* v. *Columbian National Life Insurance Company* (1912) 20 Cal. App. 21.

II.

THE SEC BELIEVES THAT IT MAY PROPERLY REGULATE IN THIS AREA AND IN FACT HAS DONE SO.

Petitioner argues that if the opinion of the court below prevails, any future regulations by the SEC in this area would be struck down.

In reply it should be pointed out that the SEC has already regulated in this area, and such regulation, although inapplicable, was in effect at the time the bonds were written.

Rule 17g-1(e) provides:

> "Where the registered management investment company is an unincorporated company managed by a depositor or investment advisor, the terms 'officer' and 'employee' shall include, for the purposes of this rule, the officers and employees of the depositor or investment advisor."

Winfield was at all times herein mentioned a corporation organized and existing under the laws of the State of Delaware (FF 2.), and consequently this section is inapplicable.[1] Furthermore, WGF was registered as an open-end diversified management investment company under the Investment Company Act of 1940. (FF 3.) Furthermore, WGF was the only entity on the Winfield bonds which had to be bonded under Rule 17g-1. (FF 159.) A copy of WGF's bond was filed with the SEC. (FF 160.) The SEC never complained concerning the adequacy of the Winfield bonds. (FF 163.) The SEC never gave appropriate notice or conducted a hearing with regard to the inadequacy under Rule 17g-1 of the Winfield bonds issued by INA. (FF 165.)

Thus, not only has the SEC partially regulated in the area, the evidence before the trial court also demonstrated that the SEC in fact reviewed the bonds and raised no objection.

Congress has not enacted any legislation requiring bonds for investment advisers. Indeed, Congress has rejected proposed legislation to authorize the SEC to require bonds for investment advisers. The Commission, however, may regulate investment companies and require such companies to bond those who advise such companies. To date, the Commission has not enacted any rule requiring a corporate investment company to bond its advisers. As the United States has noted, this problem may be solved by the adoption of proper rules. The solution to this problem should be left to the Commission.

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[1] The detailed findings of fact and conclusions of law are set forth in Appendix B to the Petition. The Court of Appeals determined that the findings of the District Court are fully supported by the evidence. (Petition, page 6a.)

III.

PETITIONER'S PREDECESSOR DELIBERATELY AND INTENTIONALLY ELECTED TO EXCLUDE TRADING COVERAGE. COVERAGE SHOULD NOT BE IMPOSED RETROACTIVELY WHERE THE INSURED PAID NO PREMIUM FOR SUCH COVERAGE AND DID NOT INTEND TO PURCHASE SUCH COVERAGE.

The United States has pointed out that the problem of requiring coverage for employees of investment advisers "can be corrected by the Securities and Exchange Commission through rule making in the exercise of its 'broad regulatory authority over the business practices of investment companies.' " (Brief of the United States, *amicus curiae*, page 5.) As further noted, "the Commission is currently developing rule proposals and is considering the initiation of rule making proceedings." (Brief of the United States, page 7.) Petitioner argues that such regulation will not be retroactive and unless the instant decision is reversed, "investors in mutual funds that have bonds like petitioner's will have been stripped of the bonding protection for losses suffered in the past through the dishonesty of portfolio managers." (Supplemental Brief of Petitioner, page 3.) We find petitioner's newly-developed concern for investors to be somewhat out of place considering the trial court's findings of fact and conclusions of law in the instant case.

The trial court specifically found:

> "34. Brokers Blanket Bond Form 14 broad form excludes losses resulting from trading from insuring clauses A, B, and C, and the exclusion may be removed by the payment of an additional premium."

> "69. Robert Lovejoy executed an application for Brokers Blanket Bonds in 1968 and therein

represented A. Stephen Sanders to be an employee of Winfield & Company."

"115. WGF did in fact exercise its independent judgment as to the amounts and coverage to be purchased under the bonds."

"117. Lovejoy had discussions with the board of WGF regarding the bonds not less than annually. He would review the bond coverage then in effect and ask the board to make a determination as to its adequacy."

"136. Hopkins testified trading loss coverage was discussed with the various and successive representatives of WGF.

"137. Trading loss coverage was available.

"138. Hopkins asked INA for quotes on trading loss coverage and obtained the same.

"139. When Hopkins reviewed the insurance coverage with WGF, he asked them whether they wished to purchase trading loss coverage and they rejected the same.

"140. The additional premium for trading loss coverage is 35% to 50% over the basic cost.

"141. Hopkins talked to Lovejoy at least annually regarding the trading loss exclusion, and Lovejoy indicated that he did not want to pay the additional premiums to delete the exclusion."

"144. Correspondence between Hopkins and Winfield & Co. made reference to the fact that Winfield & Co. had no coverage on trading losses.

"145. WGF and Winfield & Co. were aware that they did not purchase trading loss coverage.

"146. There were occasions when Hopkins told Winfield certain forms of insurance were available, but they rejected it. Coate made the decision not to remove the exclusion. Hopkins talked about

the trading loss exclusion with Lovejoy, Coate, and Jack Deignan at least annually, and they were aware that they did not have trading loss coverage.

"147. With regard to Exhibit BN, Hopkins prepared the agenda of items to discuss with Winfield representatives with regard to bond coverage. On that exhibit, following the words 'trading loss' appears the word 'no'. That word was inserted during Hopkins' discussion with the Winfield representatives who indicated to him that they did not want trading loss coverage."

"150. On January 10, 1969, WGF was aware that it had no trading loss coverage."

"185. WGF recognized that it was trading."

"192. The directors of Winfield & Co. were aware that the purchase and sale of securities constituted trading."

The District Court concluded:

"13. The insureds had no reasonable expectation that the losses of the character sustained by them in this case would be covered under INA's bonds."

When it was purchasing coverage and paying premiums for such coverage, petitioner's predecessor in interest elected not to obtain trading loss coverage for itself or employees of its investment adviser. It deliberately and intentionally elected to exclude such coverage. Now, petitioner requests that this Court impose coverage which petitioner's predecessor chose to exclude and for which it never paid a premium. If there is a problem in the area which should be solved, it should be done prospectively so that insurers and insureds alike will know that such coverage must be provided and that a reasonable premium may be charged for the risk which is insured. Congress has not

previously enacted legislation requiring bonds for investment advisers and where the Commission has not to this point enacted regulations covering the instant situation, any change in the law should be done prospectively. The United States Court of Appeals for the Ninth Circuit properly affirmed the judgment which was predicated upon the reasonable expectation of the parties. This Court should not require or impose coverage which petitioner deliberately chose to exclude.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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THE INSURANCE COMPANY OF NORTH AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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OCTOBER TERM, 1979

No. 79-584

RESEARCH EQUITY FUND, INC., PETITIONER

v.

THE INSURANCE COMPANY OF NORTH AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

This brief is filed in response to the Court's invitation to the Solicitor General to express the views of the United States.

QUESTION PRESENTED

Whether, in the circumstances of this case, a portfolio manager provided to an open-end management investment company by its investment adviser is an "employee" of the investment company within the meaning of Securities and Exchange Commission Rule 17g-1, 17 C.F.R. 270.17g-1, promulgated under Section 17(g) of the Investment Company Act of 1940, 15 U.S.C. 80a-17(g), and is thus subject to the fidelity bonding requirements of those provisions.

STATEMENT

Petitioner, an open-end management investment company (commonly known as a mutual fund), brought suit to recover on fidelity bonds for losses suffered as a result

of the dishonest acts of its portfolio manager, A. Stephen Sanders, whose services were provided to petitioner by its investment adviser under a management contract.[1] The fidelity bonds involved in this case were joint investment company-investment adviser bonds issued by respondent. The district court entered judgment in favor of respondent (Pet. App. 11a-47a), and the court of appeals affirmed (*id.* at 1a-10a).

The court of appeals found that Sanders was among the persons whose acts were covered by the fidelity bonds (Pet. App. 4a). The court nonetheless concluded that the "trading loss" exclusion contained in the bonds would bar recovery for losses resulting from Sanders' acts unless, as "statutory bonds," the bonds must be given a broader interpretation by virtue of SEC Rule 17g-1, 17 C.F.R. 270.17g-1, adopted under Section 17(g) of the Investment Company Act of 1940, 15 U.S.C. 80a-17(g) (Pet. App. 6a).[2]

The court then analyzed the scope of the bonding requirements imposed by Rule 17g-1. The court concluded that Sanders had committed "larceny" and "embezzlement" within the meaning of Rule 17g-1 and accordingly that the loss suffered by the fund was the

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[1]Sanders caused the investment company to purchase securities with knowledge that the prices of those securities were being manipulated and without regard to their investment merits. In return for this action, he received payments from the persons engaged in the manipulation (Pet. App. 24a).

[2]"Statutory bonds" are bonds obtained to satisfy a duty prescribed by statute. A statutory bond is interpreted to conform to the requirements of the statute under which it is obtained. See Pet. App. 6a; *Index Fund, Inc.* v. *Insurance Company of North America*, 580 F. 2d 1158, 1162 (2d Cir. 1978); *American Casualty Co.* v. *Irvin*, 426 F. 2d 647, 650 (5th Cir. 1970).

type of loss for which bonding is required (Pet. App. 7a).[3] It nonetheless held that the statutory bond doctrine would not support recovery in this case because "the statute does not require coverage for the losses suffered * * * at the hands of someone such as Sanders * * *" (Pet. App. 10a).

In the court's view, Sanders was not properly regarded as one of petitioner's "employees," but instead was solely an employee of its investment adviser (Pet. App. 7a-10a). While the court recognized that mutual funds generally do not have employees of their own and rely on their advisers' employees to perform managerial and administrative functions (Pet. App. 8a), it concluded that Rule 17g-1 does not require mutual funds to be bonded for larceny or embezzlement committed by the employees of their advisers (Pet. App. 8a-9a).

DISCUSSION

1. In our view, the court of appeals' interpretation of the term "employee" as used in Rule 17g-1 is overly restrictive and erroneous. Moreover, the issue presented by this case is an important one because the bonding requirements of the Investment Company Act provide essential protection for investors.

As the court of appeals recognized (Pet. App. 7a), Congress intended to grant the Securities and Exchange Commission authority to impose bonding requirements to protect mutual funds and their shareholders from larceny and embezzlement, including activities of the kind in which Sanders engaged. Rule 17g-1, which reiterates the language of Section 17(g) of the Act, imposes such requirements. Yet as a result of the court

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[3]See *Index Fund, Inc.* v. *Insurance Company of North America*, *supra*, 580 F. 2d at 1163.

of appeals' decision, petitioner and its shareholders have been denied the protection of bonding simply because petitioner was managed by personnel who were hired by an adviser with whom petitioner had a management contract.

The court of appeals recognized that the relationship between petitioner and its investment adviser—a relationship in which the adviser provided management services through personnel who "functioned as if they were * * * [the investment company's] employees"—is "the norm in the industry" (Pet. App. 8a).[4] Under these circumstances, as the Commission stated in its memorandum in support of the petition for rehearing in the court of appeals:[5]

> [T]he result of the [court of appeals'] holding is that (i) the bonding requirements would have minimal application to [mutual funds managed by an external advisory firm] and (ii) their applicability would be dependent upon whether the company happens to be managed internally rather than by an external advisory firm. Congress could hardly have intended such an anomalous result.

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[4]See *Burks* v. *Lasker*, 441 U.S. 471, 480-481 (1979) ("'[m]utual funds, with rare exception, are not operated by their own employees. Most funds are formed, sold, and managed by external organizations, [called 'investment advisers,'] * * *. The advisers select the funds' investments and operate their businesses * * *," quoting S. Rep. No. 91-184, 91st Cong., 1st Sess. 5 (1969)).

[5]The Commission participated as amicus curiae in this case in support of petitioner, filing a memorandum in the district court, a statement of its views in the court of appeals, and a memorandum in support of rehearing in that court.

By placing the corrupt activities of the adviser's employees beyond the reach of the bonding requirements of Rule 17g-1, the court of appeals failed to interpret those requirements "in a manner most conducive to [their] goals." *United States* v. *National Association of Securities Dealers, Inc.*, 422 U.S. 694, 720 (1975).[6]

2. Although we believe that the issue presented in this case is important and the decision of the court of appeals is erroneous, we note that the decision below is the only appellate decision dealing with this issue. Moreover, the decision was rendered in the absence of a Commission rule explicitly addressing the question whether bonding is required for personnel furnished to a mutual fund such as petitioner by its adviser. In our view, the problem created by the court of appeals' decision can be corrected by the Securities and Exchange Commission through rulemaking in the exercise of its "broad regulatory authority over the business practices of investment companies." *E.I. du Pont de Nemours & Co.* v. *Collins*, 432 U.S. 46, 52 (1977), quoting *United States* v. *National Association of Securities Dealers, Inc.*, *supra*, 422 U.S. at 704-705.

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[6]In construing the term "employee" under other statutes, this Court has recognized that the term "derives meaning from the context of [the] statute, which 'must be read in the light of the mischief to be corrected and the end to be attained.' " *NLRB* v. *Hearst Publications, Inc.*, 322 U.S. 111, 124 (1944). See also *United States* v. *Silk*, 331 U.S. 704, 712 (1947) ("the term[] 'employee' [is] to be construed to accomplish the purposes of the legislation. * * * [A] constricted interpretation of the phrasing by the courts would not comport with [the legislative] purpose.").

Throughout the Investment Company Act, Congress has granted the Commission broad rulemaking powers. In addition to numerous specific grants of rulemaking authority,[7] Section 38(a) of the Act, 15 U.S.C. 80a-37(a), empowers the Commission to "make * * * such rules and regulations * * * as are necessary or appropriate to the exercise of the powers conferred upon the Commission" under the Act. Section 38(a) also grants the Commission authority to define "technical" and "trade" terms used in the Act.

Further specification of fidelity bonding requirements under the Act is a matter requiring the Commission's administrative expertise. Section 17(g) of the Act is not self-executing. It is only through the exercise of the Commission's rulemaking authority under that provision that bonding is required at all. In light of the technical nature of bonding requirements, it is appropriate for the Commission to develop rule proposals that would fill the gap in protection created by the court of appeals' ruling, as well as any other inadequacies in the industry's

[7]See Sections 6(c), 6(d), 8(b), 8(c), 8(d), 10(e)(3), 10(f), 11(a), 12(a), 12(b), 17(d), 17(e)(2)(C), 17(f), 17(g), 17(j), 18(f)(1), 18(j)(2), 19(a), 19(b), 20(a), 22(b)(2), 22(c), 22(e)(3), 22(f), 23(b), 23(c)(3), 24(a)(1), 24(c), 24(d), 24(e)(3), 24(f), 27(b), 27(d), 27(e), 27(f), 28(a)(2)(G), 28(b), 28(c), 28(d)(5), 30(c), 30(d), 30(e), 31(a), 31(c), 32(c), 38(b), 40(c), and 45(a) of the Investment Company Act of 1940, 15 U.S.C. 80a-6(c), 80a-6(d), 80a-8(b), 80a-8(c), 80a-8(d), 80a-10(e)(3), 80a-10(f), 80a-11(a), 80a-12(a), 80a-12(b), 80a-17(d), 80a-17(e)(2)(C), 80a-17(f), 80a-17(g), 80a-17(j), 80a-18(f)(1), 80a-18(j)(2), 80a-19(a), 80a-19(b), 80a-20(a), 80a-22(b)(2), 80a-22(c), 80a-22(e)(3), 80a-22(f), 80a-23(b), 80a-23(c)(3), 80a-24(a)(1), 80a-24(c), 80a-24(d), 80a-24(e)(3), 80a-24(f), 80a-27(b), 80a-27(d), 80a-27(e), 80a-27(f), 80a-28(a)(2)(G), 80a-28(b), 80a-28(c), 80a-28(d)(5), 80a-29(c), 80a-29(d), 80a-29(e), 80a-30(a), 80a-30(c), 80a-31(c), 80a-37(b), 80a-39(c), and 80a-44(a).

present bonding practices. See generally *Mourning* v. *Family Publications Service, Inc.*, 411 U.S. 356, 369 (1973); *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 476-477 (1979).[8]

The Commission is currently developing rule proposals and is considering the initiation of rulemaking proceedings. The Commission has already brought to the industry's attention certain problems created by a restrictive interpretation of the bonding requirements. Following the district court's decision in this case, the Commission issued a release, expressing the views of its Division of Investment Management, which recommended that the disinterested directors of mutual funds review fidelity bonds now in effect in light of "their fiduciary responsibilities under the Act to assure that the investment companies which they serve have fidelity bond coverage which both satisfies the requirements of * * * Rule [17g-1] and offers adequate protection to shareholders." Investment Company Act Release No. 10393 (Sept. 8, 1978), 15 SEC Docket 1082, 1085.

[8]In light of the purpose served by bonding and the common practice in the mutual fund industry for investment advisers to furnish mutual funds with personnel, a regulation defining the term "employee," as it is used in Section 17(g) and Rule 17g-1, to include such personnel may be appropriate. See Rule 17g-1(i) under the Investment Company Act of 1940, 17 C.F.R. 270.17g-1(i), defining the terms "officer" and "employee" to include officers and employees of an investment adviser to an unincorporated open-end management investment company. See also Investment Company Act Release No. 214 (Sept. 15, 1941), expressing the view of the Commission's General Counsel that the term "employee," as it was used in Section 10(a) of the Investment Company Act of 1940, 54 Stat. 806 (current version at 15 U.S.C. 80a-10(a)), includes attorneys on a general retainer from an investment company.

CONCLUSION

While we are of the view that the decision of the court of appeals is erroneous and that the question involved is important, we believe that review by this Court at this time is not essential in light of the Commission's rulemaking authority.

WADE H. MCCREE, JR.
Solicitor General

RALPH C. FERRARA
General Counsel
Securities and Exchange Commission

FEBRUARY 1980

DOJ-1980-02

IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

No. 79-584

RESEARCH EQUITY FUND, INC.,

Petitioner,

v.

THE INSURANCE COMPANY OF NORTH AMERICA,

Respondent.

BRIEF OF INVESTMENT COMPANY INSTITUTE, *AMICUS CURIAE*, IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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October 10, 1979

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Investment Company Institute

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Preliminary Statement—Interest of Investment Company Institute

This brief is submitted, with the consent of the parties,* by the Investment Company Institute ("ICI") as *amicus curiae* in support of the petition of plaintiff Research Equity Fund, Inc. for a writ of certiorari to the United States Court of Appeals for the Ninth Circuit.

ICI, a voluntary association headquartered in Washington, D. C., is the national association of open-end investment companies (or "mutual funds", as they are

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* Letters from counsel of record for the parties, expressing their consent to ICI's submission of *amicus curiae* briefs, are reproduced in the Appendix to this brief.

commonly known), their advisers and underwriters. ICI has 487 investment company members having approximately 7 million shareholders and assets of approximately $65 billion, which is about ninety per cent of the total assets of the mutual fund industry. All of the mutual fund members of ICI are registered with the Securities and Exchange Commission ("SEC") under the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1, *et seq.* ("Act"). The decision of the Court of Appeals, if allowed to stand, would have an adverse impact upon ICI's investment company members and their 7 million shareholders.

Statement of the Case and Question Presented

Like most of the mutual funds in this country, petitioner Research Equity Fund, formerly known as Winfield Growth Fund, Inc. ("Fund"), has no salaried employees of its own, but is managed pursuant to contract by a separate investment advisory or management company. The manager, Winfield & Co. ("Manager"), is charged with the responsibility of managing the Fund's securities portfolio and, in addition, furnishes to the Fund such administrative services and personnel as the business of the Fund may require. All Fund officers were also officers of the Manager. (8a)*

Section 17(g) of the Act and SEC Rule 17g-1 require the Fund to maintain a fidelity bond to protect the Fund and its shareholders against larceny and embezzlement by its officers and employees. (2a) Petitioner purchased such a bond and suffered loss when a portfolio manager employed by the Manager was bribed to purchase securities whose prices had been inflated by manipulation. (2a-3a)

* Citations to "—a" are to the designated pages of the Appendix to the Petition for a Writ of Certiorari.

The Court of Appeals apparently ruled that the Fund's fidelity bond was a "statutory bond" and therefore had to be interpreted to provide the fidelity coverage mandated by the Act. (7a)

The question presented on these facts is whether a management company employee, who manages the portfolio of a mutual fund which has no employees of its own, is a fund employee within the meaning of Section 17(g) and SEC Rule 17g-1, and hence a person as to whom the Act mandates fidelity coverage.

Statement of the Facts

A. Stephen Sanders, who was employed directly by the Manager, acted as portfolio manager for the Fund, with the responsibility for deciding which securities should be purchased or sold for the Fund's portfolio. (2a) Sanders acted under the immediate supervision of an individual who was an officer of both the Fund and the Manager. (2a) During the period from December, 1969, through March, 1970, Sanders accepted bribes for recommending the Fund's purchase of certain securities at prices he knew to be artificially inflated as a result of manipulation. The Fund suffered losses in selling the securities after the scheme was discovered. (2a-3a)

As required by Section 17(g) of the Act and SEC Rule 17g-1,* the Fund maintained fidelity insurance bonds against losses resulting from dishonest acts by Fund officers and

* In Section 17(g), 15 U.S.C. § 80a-17(g), Congress conferred specific authority upon the SEC to adopt rules for the protection of investors requiring:

> ". . . that any officer or employee of a registered management investment company who may singly, or jointly with others, have access to securities or funds of any registered company,

(footnote continued on following page)

employees who have "authority . . . to direct generally the disposition of [its] securities". Respondent Insurance Company of North America ("INA"), the issuer of the bonds—which were in the standard form issued to stockbrokers, investment bankers and mutual funds throughout the industry—denied coverage for the Fund's losses and the Fund instituted the present action. (3a, 17a)

The District Court concluded that the bonds did not cover the losses and dismissed the action. (49a) The District Court's judgment was affirmed by the Court of Appeals on the basis of two holdings: (1) that the losses were excluded from coverage by the plain meaning of the standard "trading loss exclusion" contained in the bonds (5a-6a); and (2) that even if the bonds were "statutory bonds" and hence should be interpreted to afford the coverage mandated by statute, Section 17(g) and Rule 17g-1 do not require coverage of losses resulting from the dishonesty of persons, such as Sanders, who are not officers of or employed directly by a mutual fund, but rather are employed by the fund's manager (7a-10a).

(footnote continued from preceding page)

> either directly or *through authority to* draw upon such funds or *direct generally the disposition of such securities* be bonded . . . against larceny and embezzlement in such reasonable minimum amounts as the Commission may prescribe." (Emphasis supplied)

The SEC implemented this Congressional grant of authority by promulgating Rule 17g-1, which requires, in pertinent part, that:

> "Each registered management investment company shall provide and maintain a bond . . . against larceny and embezzlement, covering each officer and employee of the investment company, who may singly, or jointly with others, have access to securities or funds of the investment company, either directly or *through authority to* draw upon such funds or to *direct generally the disposition of such securities*. . . ." 17 C.F.R. § 270.17g-1 (Emphasis supplied)

Reasons for Granting the Writ

The Decision Below Undermines an Important Protection Which Congress Intended to Guarantee to Mutual Fund Shareholders by Violating the Act's Plain Language and Manifest Purpose, and Ignoring the Management Structure Prevailing Throughout the Mutual Fund Industry.

A. Statutory Language

If the decision of the Court of Appeals is allowed to stand, it would substantially erode a significant protection mandated by Congress for the millions of persons—largely of ordinary means—whose savings are invested in mutual funds. A mutual fund's business is the management of its portfolio. The Fund here suffered losses because of the dishonesty of its portfolio manager. It defies common sense to hold, as the Court of Appeals did, that Congress did not intend such losses to be covered because the thief was technically not an employee of the Fund in that his salary was paid by the Manager rather than directly by the Fund.

As the Second Circuit held in *Index Fund, Inc.* v. *Insurance Co. of North America,* 580 F.2d 1158 (1978), *cert. den.,* 99 S. Ct. 1226 (1979)—and as the Court of Appeals below apparently concurred (7a)—a fidelity bond of the type at issue here must be construed to provide coverage coextensive with that mandated by Section 17(g) of the Act and Rule 17g-1.* Rule 17g-1 describes the individuals required to be covered by mutual fund fidelity bonds as follows:

> ". . . each officer and employee of the investment company, who may singly, or jointly with others, have access to securities or funds of the investment com-

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* The Second Circuit specifically held that a bond's "trading loss" exclusion does not insulate respondent insurer from liability if Rule 17g-1 mandates coverage for the losses sustained.

pany, either directly or through authority to draw upon such funds or to direct generally the disposition of such securities. . . ."

Since neither the Rule nor the Act defines the term "employee", the term must be given its common-sense meaning. A mutual fund portfolio manager is a fund employee whether or not his salary is paid directly by the fund, and whether or not he is also an employee of the fund's manager. It is well established that the same individual can be subject to the supervision, direction and control—and hence be the "employee"—of more than one entity.* *E.g., Peters* v. *United Studios, Inc.*, 98 Cal. App. 373, 379, 277 P. 156 (1929); *Parke-Bernet Galleries, Inc.* v. *Franklyn*, 26 N.Y.2d 13, 18-19, 308 N.Y.S.2d 337, 256 N.E.2d 506 (1970). Here, because Sanders, in his role as Fund portfolio manager, was subject to the supervision, direction and control of the Fund's Board of Directors, he was a Fund employee. (2a)

The only limitation upon the term "employee" which is imposed by Rule 17g-1 concerns the authority of the employee with respect to a mutual fund's securities or cash. As portfolio manager for the Fund, "with authority to direct generally the disposition" of its securities, Sanders was a Fund employee under the meaning of Rule 17g-1.

B. Statutory Purpose

The importance of the case is also manifest in the fact that theft by portfolio managers is precisely the kind of conduct against which the Act intended to protect mutual fund shareholders. In the Findings and Declarations of Policy contained in Section 1 of the Act, Congress stated:

* This principle is recognized by Section 17(g) itself, which expressly excludes from its scope an "officer or employee [who] has such access [to a mutual fund's securities or cash] solely through his position as an officer or employee of a bank"; *i.e.*, the statute recognizes that a person who is an employee of a bank can also be an employee of a mutual fund.

"Upon the basis of the facts disclosed by the record and reports of the Securities and Exchange Commission . . . and facts otherwise disclosed and ascertained, it is hereby declared that the national public interest and the interest of investors are adversely affected—

* * *

"[W]hen investment companies are organized, operated, managed, or *their portfolio securities are selected, in the interest of directors, officers, investment advisers, or other affiliated persons* thereof . . . rather than in the interest of all classes of such companies' security holders." Act, Section 1(b)(2), 15 U.S.C. § 80a-1(b)(2) (Emphasis supplied)

Congress implemented that policy by a number of interrelated prohibitions. Thus, Sections 17(a), (d) and (e) of the Act, 15 U.S.C. § 80a-17(a), (d), (e), generally prohibit mutual fund employees and others from engaging in transactions with the fund except in precisely enumerated circumstances. Section 17(f), 15 U.S.C. § 80a-17(f), requires that a mutual fund maintain its assets in the custody of a bank or other qualified institution. Other provisions of the Act require that "disinterested" directors, not affiliated in any way with a mutual fund's manager, constitute a majority or significant minority of the fund's board of directors and delegate specific "watchdog" responsibilities to the disinterested directors. Section 10(a), 15 U.S.C. § 80a-10; *see Tannenbaum* v. *Zeller*, 552 F.2d 402, 406 (2d Cir. 1977), *cert. den.*, 434 U.S. 934; *Fogel* v. *Chestnutt*, 533 F.2d 731, 749 (2d Cir. 1975).

But since a clever thief can at times deceive even the most alert watchdog, Congress provided in Section 17(g) that fund shareholders were also to be protected by fidelity bonds. It is readily apparent from the scheme of the Act that Congress intended the bonding protection mandated by Section 17(g) to cover the dishonest acts of all those pos-

sessing authority to direct the disposition of a mutual fund's securities or money, regardless of whether such persons are technically employed by a mutual fund or are employed instead by the fund manager.

C. Management Structure Prevailing Throughout Mutual Fund Industry

If allowed to stand, the Court of Appeals' erroneous decision would have a pervasive adverse impact upon the mutual fund industry and mutual fund shareholders. As the Court of Appeals recognized, most mutual funds in the United States, like petitioner Fund, are managed externally, that is by separate investment advisory or management companies. (8a) Most mutual funds have no employees of their own and delegate the day-to-day management functions to a separate management company. Thus, the Second Circuit said in *Tannenbaum* v. *Zeller,* 552 F.2d 402, 405 (1977), *cert. denied,* 434 U.S. 934:

> "The mutual fund industry is in many ways unique, which in part explains the specific federal regulatory legislation concerning it. A mutual fund is a 'mere shell,' a pool of assets consisting mostly of portfolio securities that belong to the individual investors holding shares in the fund. The management of this asset pool is largely in the hands of an investment adviser, an independent entity which generally organizes the fund and provides it with investment advice, management services, and office space and staff. The adviser either selects or recommends the fund's investments and rate of portfolio turnover, and operates or supervises most of the other phases of the fund's business. The adviser's compensation for these services is a fee which is usually calculated as a percentage of the fund's net assets, and thus fluctuates with the value of the fund's portfolio."

See *Burks* v. *Lasker,* 99 S.Ct. 1831, 1838 (1979); *Fogel* v. *Chestnutt,* 533 F.2d 731, 734-35 (2d Cir. 1975); REPORT OF

THE SECURITIES AND EXCHANGE COMMISSION ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H. R. REP. 2337, 89th Cong., 2d Sess. 45-47, 49-50 (1966).

The Court of Appeals sought to support its reasoning by noting that Congress was aware of the unique structure of the mutual fund industry and by ascribing significance to Congress' failure to require fidelity bonds for investment advisers registered under the Investment Advisers Act, 15 U.S.C. § 80b-1, *et seq.* (8a-9a) That failure has no significance here, for when Section 17(g) of the Investment Company Act was enacted in 1940, at the same time that the Investment Advisers Act was enacted, investment advisers whose sole business was the management of mutual funds were exempt from regulation under the Investment Advisers Act. Section 203, 54 Stat. 850 (1940). That exemption was not repealed until 1970. 15 U.S.C. § 80b-3(b)(2), amended by Pub. L. 91-547, § 24(a), 184 Stat. 1430 (1970). Thus, nothing in the history of the Investment Company Act or its amendments supports the constrictive definition which the Court of Appeals gave to the term "employee".

A far more plausible definition was given by the SEC as long ago as 1941, when the SEC General Counsel issued an opinion* to the effect that attorneys on general retainer from a mutual fund are "employees" of the fund, as that term is used in Section 10(a) of the Act, which at the time prohibited a mutual fund from having a board of directors of which more than sixty percent were "employees" or persons in other specified relations to the fund. The SEC's General Counsel expressed the view that the term "employee" "must be interpreted in light of the purpose of the particular section and the evil sought to be remedied thereby." Since the intention of Section 10(a) was to insure

* Investment Company Act Release No. 214 (Sept. 15, 1941), (CCH) Fed. Sec. L. Rep. ¶ 48,032.

that at least forty percent of the board was independent of the mutual fund's management, and since counsel employed on a general retainer was "so closely related to the management that he cannot be considered to be the 'independent' type of person which the Act contemplates," counsel was not to be considered an "independent" director of the fund.

If the term "employee" in Section 17(g) of the Act is also defined "in light of the purpose of [the Act] and the evil sought to be remedied thereby", it is obvious that such term must include persons like Sanders who perform the vital function of portfolio management—a mutual fund's central function, the dishonest performance of which it was the Act's specific goal to prevent.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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MARVIN SCHWARTZ,
NADINE STROSSEN,
Of Counsel

October 10, 1979

Of Counsel:
MATTHEW P. FINK,
STEVEN J. PAGGIOLI,
Investment Company Institute

APPENDIX

[Letterhead of SHARP, RANDOLPH & GREEN]

September 27, 1979

Sullivan & Cromwell
125 Broad Street
New York, New York 10004

Re: *Research Equity Fund, Inc.* v. *The Insurance Company of North America,* 9th Cir., No. 77-1467

Dear Sirs:

On behalf of Research Equity Fund, Inc., I hereby consent to the Investment Company Institute's filing a brief *amicus curiae* in the Supreme Court with respect to the petition for a writ of certiorari that Research Equity will file in the above case.

Sincerely yours,

/s/ A. RAYMOND RANDOLPH, JR.

A. Raymond Randolph, Jr.

Attorney for
Research Equity Fund, Inc.

AAR/st

[Letterhead of SWANER, LESLIE & DERIMAN]

September 28, 1979

Nadine Strossen, Esq.
Sullivan & Cromwell
125 Broad Street
New York, New York 10004

Re: Certiorari Petition in the Supreme Court in *Research Equity Fund, Inc.* v. *The Insurance Company of North America*

Insured:	Winfield & Co., Inc.
INA File:	986 B 34 28 47
Our File:	52-242

Dear Ms. Strossen:

This will confirm our several telephone conversations this past week, wherein you advised that your firm represents the Investment Company Institute and you have been requested by your client to file an amicus brief at the certiorari stage, but that you need the consent of Insurance Company of North America, in lieu of making a Motion.

I have just received a letter from Attorney Randolph, representing Research Equity, confirming that if INA consents to the filing to such an amicus brief by Investment Company Institute, that counsel for Research Equity Fund, Inc., will in turn consent in writing to the filing of an amicus brief by the Surety Association of America.

While Mr. Randolph's letter goes to the filing of an amicus brief at the certiorari level only, I believe our understanding goes beyond that and if the Supreme Court grants certiorari, it is my understanding that Research Equity would

consent to a brief on the merits by Surety Association of America, provided INA consents to a brief on the merits by the Investment Company Institute.

If Mr. Randolph has any disagreement with that understanding, he should let me know immediately.

In any event, in light of my agreement with Mr. Randolph, this is INA's consent to the filing of an amicus brief at the certiorari stage in the above case by the Investment Company Institute.

Naturally, this approval is contingent upon your expeditious filing of the amicus brief so that there is no undue delay in these proceedings.

Incidentally, any copies of pleadings should be served on Robert A. Seligson, Esq., 300 Montgomery Street, San Francisco, California 94104, as well as this firm, as he is counsel of record in this matter.

Very truly yours,

/s/ ROBERT E. LESLIE

ROBERT E. LESLIE

REL:mr

cc: Mr. Robert R. Danner, INA
Robert A. Seligson, Esq.
A. Raymond Randolph, Jr., Esq.